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THE MARKET REFORM ACT OF 1989

JOINT HEARINGS

BEFORE THE

SUBCOMMITTEE ON SECURITIES

AND THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

S. 648

TO AMEND THE SECURITIES EXCHANGE ACT OF 1934

THE STEEP MARKET DECLINES OF OCTOBER 1987 AND OCTOBER 13, 1989, ALSO ISSUES RELATING TO MARKET VOLATILITY; PROGRAM TRADING'S EFFECT ON INVESTOR CONFIDENCE AND MARKET STABILITY; LEVERAGE BUYOUTS; INTERMARKET COORDINATION OF DOMESTIC AND INTERNATIONAL SECURITIES MARKETS

MAY 18 AND OCTOBER 26, 1989

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CONTENTS

THURSDAY, MAY 18, 1989

Page
Opening statement of Senator Dodd 1
Opening statements of:
    Senator Dixon 3
    Senator Heinz 4
    Chairman Riegle 5
    Senator Gramm 7
    Senator Wirth 8
    Senator Sasser 10
    Senator D'Amato 11
    Senator Sanford 12
Senator bill S. 648 15

WITNESSES

John Phelan, chairman and chief executive officer, New York Stock Exchange, New York, NY 28
    Prepared statement 31
Joseph Hardiman, president, National Association of Securities Dealers 58
    Prepared statement 61
Leo Melamed, chairman, executive committee, Chicago Mercantile Exchange 77
    Prepared statement 79
Jeffrey B. Lane, president and chief operating officer, Shearson Lehman Hutton, Inc., New York, NY 134
    Prepared statement 138
George S. Bissell, chief executive officer, Keystone Massachusetts Group, Boston, MA 152
    Prepared statement 156

THURSDAY, OCTOBER 26, 1989

Opening statement of Senator Dodd 193
Opening statements of:
    Senator Heinz 195
    Chairman Riegle 196
    Senator Garn 197
    Senator Sarbanes 198
    Senator D'Amato 199
    Senator Dixon 199
    Senator Gramm 200
    Senator Shelby 201
    Senator Mack 203
    Senator Bryan 228

WITNESSES

Nicholas F. Brady, Secretary, U.S. Department of the Treasury 208
    Prepared statement 213

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

Statement of Charles R. Schwab, chairman, Charles Schwab & Co., Inc 267
Opinion Research Corp., Investor Attitudes Questionnaire 275

Page
Opinion Research Corp., a report prepared for the National Association of Securities Dealers 289
Opinion Research Corp., Form 19b-4, proposed rule change by the New York Stock Exchange 304
Letter to Senator Dodd from the Securities and Exchange Commission, dated, May 17, 1989 342
Letter to Senator Dodd from Michael Raoul-Duval, managing director, The First Boston Corp., dated, July 6, 1989 367
Letter to David S. Ruder, Chairman, Securities and Exchange Commission from Senator Dodd, dated, July 17, 1989 378
Letter to Senator Dodd from David S. Ruder, Chairman, Securities and Exchange Commission, dated, September 7, 1989 379
Letter to Senator Dodd from John L. Watson III, president, Securities Traders Association, dated, July 25, 1989 402
Letter to Senator Dodd from Joseph R. Hardiman, president, National Association of Securities Dealers, dated, September 25, 1989 405
Letter to Senator Dodd from Michael Raoul-Duval, managing director, dated, October 12, 1989, The First Boston Corp. 414
Letter to Senators Dodd and Heinz from Stephen J. Friedman, executive vice president and general counsel, The Equitable Financial Companies, dated, October 16, 1989 419
Letter to Senators Dodd and Heinz from John B. Manning, Jr., vice president and general counsel, Merrill Lynch, dated, October 19, 1989 422

THE MARKET REFORM ACT OF 1989

THURSDAY, MAY 18, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 10:05 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Christopher Dodd (chairman of the subcommittee) presiding.

Present: Senators Dodd, Sasser, Wirth, Riegle, Heinz, Pressler, D'Amato, and Gramm.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. The Subcommittee on Securities will come to order.

This morning we will conduct a hearing on S. 648, the Market Reform Act of 1989. We welcome everyone to the subcommittee's hearing.

I want to begin by thanking our very distinguished witnesses for appearing here today and for working with us on this legislation as well as the broader issues of market reform.

The issues that we will examine today are not new ones. Senator Riegle, the Chairman of the full committee, who is with us this morning, devoted enormous energies to this area in the last Congress, and the hearing this morning builds upon much of the work that he did.

Let me add that I very much appreciate his support for the subcommittee's efforts on this legislation. I feel confident that with that support, we will be able to move through some very complicated matters which are also tremendously important to public shareholders and to our economy as a whole.

I believe that we have a very constructive morning in front of us. We are considering this legislation almost 19 months after the largest stock market drop in our Nation's history.

In a period of 4 trading days ending October 19, 1987, there was a loss in value of all outstanding U.S. stocks of approximately $1 trillion, according to the Brady Commission report.

On the following day, October 20th, the U.S. markets, which have long been viewed as the strongest and fairest capital markets in the world, reached a point of near failure. In the midst of extreme volatility, surging volume and collapsing prices, traders were strapped for capital, market participants were unable to move securities positions, and funds quickly enough to meet obligations, and the resulting liquidity crisis threatened the financial system as a whole.

In the face of plunging prices and extreme confusion, investors were unable to reach their brokers, and the resulting loss of confidence drove many individual investors from the market. Many, I would add, have yet to return.

The number of initial public offerings, our basic mechanism for capital formation, even now remains well below 1987 levels. None of us believes we can or should even attempt to stop markets from falling. Investors in our securities markets have never been promised a risk-free return, but we can promise them markets that are fair, markets that are orderly markets, in which every investor—large or small—can have confidence.

With that as our goal, let me say that the witnesses in our first panel have led their organizations through some very important reforms. In almost every area of weakness revealed by the crash, from capital standards to systems enhancements to contingency planning and circuit breakers, tremendous progress has been made, and the witnesses here this morning deserve our thanks for their efforts.

I might say that it is tempting to look at those accomplishments and to look at yesterday's Dow, which reached 2462 points, and see that those numbers are not far from the 2500 level where the market stood on October 13, 1987. Thus, we regained most of what we lost in that week long market correction.

I would ask our witnesses today if they believe if we can accept what appears to be the market's judgment. Have we done enough, or is there more work to be done?

This morning I would like to divide the subcommittee's work into three areas.

First, we will examine the four provisions of the legislation before us, which were requested by the Securities and Exchange Commission—emergency powers, large trade reporting, risk assessment, and coordinated clearing. Many experts view these as modest but important steps to address some of the concerns raised in the post-crash reports. Others view the provisions as overly broad. We will look at them carefully this morning.

Second, we need to question whether other concerns raised in the wake of the 1987 crash should be addressed legislatively.

For example, the Brady Commission recommended that margin levels be harmonized across the stock options and futures markets. This has not happened. In fact, only recently margins on stock index futures on the Chicago Mercantile Exchange were lowered below pre-crash levels. We must ask in the absence of legislation are margin levels sufficient to control speculation.

Senator Heinz has raised this issue in legislation last year, and I am confident this morning he will lead the debate.

In another area, the Brady report recommended that one agency be responsible for those areas that span the stock, options and futures markets. Do our witnesses today believe there is sufficient coordination at the highest levels of Government to address intermarket concerns?

In this regard, it is disturbing that the White House Working Group on Financial Markets has not met formally since last fall.

Clearly, the FSLIC crisis has demanded most of the Treasury's attention for many months, but we want to avoid lurching from crisis to crisis.

Senator Heinz and I have asked Treasury to appear before this committee on market reform issues as soon as it can do so. I might add, last evening at the White House those of us who serve on the Budget Committee had the opportunity to chat briefly with the Secretary of the Treasury. I asked him at that point if he could respond as soon as possible to those legislative concerns, and he said he would.

Finally, we need to look into the future. Our markets are changing rapidly and dramatically. New financial instruments and exotic new trading strategies are constantly evolving. It has been suggested that we are moving toward global markets and 24-hour trading and that this trend will continue and probably accelerate.

This morning I hope we can take advantage of the expertise of our witnesses and ask what shall we be doing now to prepare for the markets of the future, what steps are being taken by the private sector, and what steps can only be taken by Government.

I want to thank again our witnesses for appearing before us this morning. I look forward to a productive hearing.

Senator Heinz, do you have any opening statement?

Senator DIXON. Mr. Chairman, I wonder if my colleague from Pennsylvania would yield just very briefly.

Mr. Chairman, I am not a member of the subcommittee. Would the Chair and my colleagues indulge me to permit me to put a very brief statement in the record?

Senator DODD. Absolutely.

Senator DIXON. I appreciate that very much. I am delighted to see these five witnesses and my good friend Leo Melamed here.

Thank you, Mr. Chairman.

STATEMENT OF SENATOR ALAN DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning as the securities subcommittee considers S. 648, The Market Reform Act of 1989, and other potential market-related legislation. Since I am not a member of the Securities subcommittee, I greatly appreciate the fact that you invited me to participate today.

We have a distinguished group of witnesses before the subcommittee this morning. I particularly want to note the presence of Leo Melamed, the chairman of the executive committee of the Chicago Mercantile Exchange. I know the subcommittee will benefit greatly from his expertise and experience in financial markets.

At the outset, I would like to congratulate Leo and John Phelan of the New York Stock Exchange for all the actions have already voluntarily taken to improve the operation of our financial matter. More needs to be done, particularly in the clearing area, but I am greatly encouraged by the start they have made, and I have no doubt that the future will see further large voluntary actions to better protect our markets in uncertain times.

I also want to reiterate one other point I have often made in the past: that we need to carefully consider the international competitive consequences of any proposed alternatives before we act. The American financial markets are the world leaders. They are the most innovative, they are the fairest, and they are the most liquid markets in the world. International competition, however, is intense. We need to take care that we do not inadvertently send business overseas that could be transacted in the United States, because if business is lost, it will not easily be regained.

Thank you, Mr. Chairman.

OPENING STATEMENT OF SENATOR HEINZ

Senator **Heinz**. Mr. Chairman, first, let me say that I am going to have to absent myself briefly. I have two other hearings I have got to go to, and I will be back as quickly as I can. One hearing is in the Finance Committee, where they need me to make a quorum. The other hearing is in the Aging Committee, where I am also Ranking Member. Fortunately, that hearing room is right above this one, with transportation as good as can be expected.

I just want to observe that 19 months ago our nation's securities markets became very seriously ill. Indeed, for a brief time the situation was truly critical, with the financial system on the verge of collapse. It took the assurance of the Federal Reserve that they were prepared to provide a capital transfusion to stabilize matters. The shock the system felt was particularly unsettling because of its unprecedented severity. The markets experienced the largest single day price decline in history, both in absolute and relative terms, falling 508 points in one day, 984 points from the August peak.

You might well say the disease proved to be contagious as well, spreading beyond our borders to affect virtually all the world's securities markets. An oft used bromide in the capital markets is that when New York sneezes Tokyo catches cold. In this case the whole world got the flu and is still feeling the after effects.

The wags and witch doctors of Wall Street proved to be lax with their post-operative diagnosis, but were quick to label a new ailment. October 19th and 20th became Black Monday and Terrible Tuesday and the 2-week period when the market lost some 25 percent of its value the Crash of 1987.

Another sage—he must have been British—referred to this period as "the great unpleasantness."

The SEC, however, thought that some people might get the wrong idea about what had transpired and instead began using the pithy phrase, "market break," which is a little bit like telling somebody with a bleeding ulcer that all they have got is gas pains.

No matter how you sugar coat it, however, it is very clear that this was a very bitter pill for many investors.

So we are here today, Mr. Chairman, for a checkup to see whether the minor surgical procedures undertaken in the past 19 months have left the markets healthy or whether the attending physicians have merely been addressing the symptoms but not the disease.

The diagnosis is not yet complete, so it would be premature to pronounce a clean bill of health. Some of the surgical refinements have yet to be tested under severe trauma conditions. For example, the new pacemakers, if you will, the circuit breakers, which were implemented and implanted last October, have received only one minor test.

Within the past week the market averages have risen to post-crash highs without strong borrowing. I note in the Wall Street Journal today an article appropriately entitled "Small Investors Sit on Sidelines Watching Stock Market Surge." I am terribly concerned about how those individual investors feel and what they think the prognosis is. They were put into a state of shock by October 19th. It seems they have never fully recovered, and it seems that very little has been done to address their needs and concerns.

So many investors feel that the increasing institutionalization of the marketplace has left them without reasonable access to the same kind of artificial life support system that the institutional players have, like program trading and portfolio insurance. It is possible that many small investors may feel that it is those market participants who cause or encourage speculation and who themselves should be—if you will excuse the expression—institutionalized.

Mr. Chairman, I look forward to hearing what our esteemed panel of witnesses has to say. I trust that they will tell it like it is and will not sugar coat the pill.

Senator DODD. I am sure of that.

Senator Riegle.

OPENING STATEMENT OF CHAIRMAN REIGLE

Chairman RIEGLE. Thank you very much, Senator Dodd.

First of all, let me commend you for what I consider to be an excellent start by this subcommittee. This is very important work that has to be done here, and the leadership that you and Senator Heinz have given to this issue, helps us enormously in terms of the work that we will carry through at the full committee level later on during the year.

I think you have planned an excellent series of hearings, which will provide the full committee with the record that it needs to act, at a minimum, in the areas of improved large trade reporting, additional SEC emergency authority, increased intermarket coordination, additional international securities enforcement cooperation, and improvement to the Shareholders Communications Act.

And as you know, I also very much support increased civil penalties in the enforcement area, continued attention being paid to the clearance and settlement process, significant additional funding for the Securities and Exchange Commission, and for some time I have been very keenly interested, along with Senator D'Amato, in clarifying and tightening the laws on insider trading, and I hope at some point we will be able to get that job completed.

Later this morning we will hear from Jeffrey Lane of Shearson Lehman Hutton. He supports clearer standards on front running. I am particularly interested in his views on that subject and other witnesses as they speak as well.

I would also strongly encourage the subcommittee as you move forward in the SEC authorization process to ensure that the new Special Study of the Securities Markets authorized in the Insider

Trading and Securities Fraud Enforcement Act of 1988 gets implemented by the Commission.

There are three over-arching trends taking place in our capital markets involving institutionalization, automation, and globalization, which must be reviewed and analyzed by some of our brightest minds if we are to retain our competitive standing in the international financial marketplace.

Finally, Mr. Chairman, it is clear that the Executive Branch has been justifiably preoccupied with FSLIC, as this committee has as well, but if they think changes are necessary in any of those areas, they cannot delay much longer in establishing their positions and priorities.

The Working Group so named to study these issues has not met since President Bush came to office, which has been mentioned already. The SEC is in a state of limbo with potentially four new appointees this year, and in the event of another major market break, which none of us want, it is uncertain exactly who will be responsible for policy coordination.

If I could make a suggestion, Mr. Chairman, I would encourage that we invite the Working Group on Market Mechanisms to testify later this summer, first to comment on the legislative initiatives which you and Senator Heinz have introduced and any others that they might recommend and, second, to ensure all of us that there is a coordinated effort at policy development on these issues at the top level within the Administration.

Let me also say that we have, I think, an outstanding panel of witnesses here before the subcommittee this morning, and I appreciate their being present. I want to make just two other points.

I recall Mr. Phelan and Mr. Melamed, as you will, 2 years ago when the market was crashing—I was serving here in the post that Senator Dodd now holds as Chairman of this subcommittee—that we were on the phone—not the three of us together, but I was on the phone with each of you around the noon hour on the Tuesday when it wasn't clear that we were going to make it on through what was a very difficult period in the aftermath of the 508-point drop in the Dow Jones on Monday.

I don't know that I will ever forget that day and the tension of the moment and the great sense of concern that everyone felt. The two of you particularly were right in the center of those storms as they were occurring. I know you don't want to get back to a situation like that. I don't think anybody else that had any adjacency to it wants to get back there again either if we can manage through adjustments and sensible policies and arrangements to try to forestall that kind of a cataclysmic set of market forces occurring.

I don't suggest that that always can be done. Markets obviously are driven by many things, but to the extent that there are steps that can be taken to help head off or moderate those kinds of massive shifts in value on a single day, I think we have an obligation to do it.

I strongly support the point that Senator Heinz made about the concern about small shareholders and whether they feel they have got a place in today's equity capital markets. I think many have decided to stay out. I think that is bad for the country. I think it is bad psychology, and I think we have to work to change it.

I don't think it is enough to concentrate on trading volume and on institutional investors. As important as institutional investors are in acting as proxies for large collections of shareholders, I think we have got to maintain a capital market system where the small investor really feels like they can come in and participate and get a fair share.

I am concerned about the degree to which we are adding strength in the equity capital markets, both new equity capital and secondary equity markets. I don't think that the pile-up of debt securities, whether they are junk bonds, high yield debt or any other name that it carries, is a sufficient substitute for equity capital and risk capital of an entrepreneurial sort, where people can come in and start businesses and increase the size of businesses, and I think that has been a key to our prosperity as a nation.

So we have got to heal any lingering sickness that there may be out there that would cause people to feel that they do not want to participate in an equity capacity in our financial markets. I think we have to make sure that we do the things that encourage that kind of participation, and I think we have some distance to go in that area, and I would like to see us figure out together the steps that can help us accomplish that.

Thank you, Mr. Chairman.

Senator DODD. Thank you, Chairman Riegle.

Our intention, of course, is to get some response from that White House working group. Obviously, it will be vitally important, and you particularly, I think, are sensitive to the problem that Treasury has had. As the Secretary said last night, it is not just the problem with FSLIC. He doesn't have all his people on board yet in terms of the number of slots that are still vacant. They have got personnel problems as well.

Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator GRAMM. Mr. Chairman, let me thank you for your recognition. I am going to run over in a minute and bash General Noriega, and I will be right then back. [Laughter.]

Chairman DODD. You can do that from here if you would like. [Laughter.]

Senator GRAMM. I am concerned that we are bashing the wrong party here.

Mr. Chairman, we have before us today representatives of the very heart of the world's greatest wealth creating machine. Our capital markets are the envy of the world. They turn the wheels of industry and agriculture in this country. They make us the richest, freest, and happiest people on earth, and I think it certainly is something that members of this subcommittee and members of the Congress ought to be concerned about, that we try in every way possible to improve the capital markets, to make them work better, and to protect the interests of the public.

Mr. Chairman, it always makes me nervous when I hear people, like our dear friend, Senator Heinz, talking about surgery and using these medical analogies. It reminds me of my old story about the farmer who had this goose that laid this golden egg.

Regular, like clockwork, she dropped this golden egg. The farmer then comes in and drains the pond, and stops feeding the goose, and burns down the coop and lets the dog loose to chase the goose around the yard. Finally, one day, the goose does not drop the egg, and immediately the farmer calls up the veterinarian and says, "You've got to get out here and operate on this goose, there is something wrong with this goose!"

Well, I guess I feel, Mr. Chairman, that before we start cutting on this goose, we should fill the pond up, rebuild the coop, start feeding the goose, and kill that dog. [Laughter.]

Then I think we can look at what we might do to the goose.

I have not closed my heart to the bill which is before the subcommittee, but I think the heavy burden of proof falls on the one who wants to start trying to tamper with this goose that has been so productive on behalf of America.

Finally, Mr. Chairman, I can't help but note one important fact about what happened when, on October 19, 1987, we had a substantial decline in the value of equities. We had a tremendous shock come through the market. I think only a fool would fail to go back and see what happened wrong and what we can improve upon, but I think also it is important to note what happened right.

The markets did not fail. America did not go into a recession. We had a financial shock that perhaps would have dislodged any other market in the world, but it did not collapse our market.

We have made changes in light of what we learned on October the 19th. I think it is wise that we have, but I think it is also important that we not destroy the very mechanism that withstood that shock.

Mr. Chairman, I look forward to these hearings. I look forward to working with you to make the equities markets in this country even better.

Only one final point. I will point out just one other element of my goose story, and that is that, as we see the consolidation of the European market—and the financial markets will be the first to consolidate—as we see other countries like Japan try to become major financial centers, it is important in everything we do in government to realize that this is a wild goose which can fly. Unless we have conditions here that are conducive to it finding happiness that we could very well find ourselves in a position where the goose is nesting somewhere else, dropping these golden eggs for Europe and Japan rather than for the United States of America.

So with all those barnyard analogies, which I prefer to these medical analogies——

[Laughter.]

Senator **Gramm** [continuing]. Which to me brings up sadness and fear, I will go over and bash Noriega, and I will be back.

Senator **Dodd**. Senator Wirth, any barnyard analogies here?

OPENING STATEMENT OF SENATOR WIRTH

Senator **Wirth**. I can hardly wait to see what Senator Gramm says to Mr. Noriega. [Laughter.]

I am reminded of an old fox that I used to have. That fox went around and what it did is it began to eat up everything else on the ranch, and we didn't hire any regulators at all to stop the fox from eating up, and it began to eat all the food from every place else and we didn't put any margin requirements on that particular fox. There wasn't anything left for anybody else to eat, and then it went out and robbed the supermarket and pretty soon all the other customers of the supermarket had to bail out that fox. Because we did nothing whatsoever, there was an enormous cost to 235 million Americans on the basis of one fox that was out of control.

Obviously, the parallel here is with the S&L industry. Having done nothing, Congress sat back, did nothing on margin requirements, didn't allow regulators to be hired, and we ended up with an extraordinary problem on our hands that is going to cost us more than $200 billion for all of the wrong reasons.

It seems to me that we want to take a good lesson from that, and we also want to take a good lesson from the near miss of October and make sure that we do not repeat the mistakes of the past.

I am pleased that we have started, Mr. Chairman, on this particular piece of legislation, and I would say to you I don't think it goes far enough. You and I and, I believe, Senator Riegle introduced this legislation a year ago on the Intermarket Coordination Act of 1988. I think we have to do more in the area of clearance and settlement. I think that is a real set of problems, and just nudging people to get together on the clearance process is probably not enough.

Jerry Corrigan, at the New York Federal Reserve, has written very eloquently on this subject. I think it is an issue that deserves a great deal of attention from us. I think on the issue of intermarket coordination that we asked the coordinating committee a year ago—Mr. Gould sat right down where you are sitting, Mr. Hardiman. I asked him when they were going to get together and start moving, and he told us they would do that right away and would be getting right back to us, and as I understand it, nothing has happened in the past year.

Some significant progress has been made, I think, in the coordination between you, Mr. Phelan, and the Chicago markets. We are grateful for that. Those are steps in the right direction. But my own instinct is that we have got to do a lot more in terms of looking very carefully at the margin issue, and I think there are some potentially biting issues there in the area of front running which we have got to be very careful about and attend to.

I am not satisfied that the kind of coordination and the kind of attention that should have been given to this issue has been given to this issue. I hope we have been more than lucky. I hope that the markets are structured in such a way that no problems are out there, but I am not convinced that that is the case.

Having just been through the very difficult task, so ably chaired by the Chairman of the committee, Senator Riegle, in getting us through at least a first cut at the S&L issue, I think we have got to be awfully careful that does not transpire again.

I think, obviously, all of us don't want to have another October. I think we want to be absolutely sure that we in this committee have done everything possible to build in where possible and where necessary the kind of very clear and clearly legislated and clearly structured coordinating devices to make sure that we have done all possible to avoid disasters in the future.

It is a good start, Senator Dodd. I appreciate it very much. I, for one, do not believe that a kind of laissez faire approach is going to serve us very well. This is a good beginning.

I thank you for being here. I thank our distinguished witnesses for once again coming down. We owe all of you and the next panel a great vote of thanks for your continuing time and attention to these issues.

A final note. I have got a hearing I am chairing on the Rocky Mountain National Park, Mr. Chairman, which is not filled with foxes and, unfortunately, not filled with very many geese either that eat up an awful lot of things, but one that has to be tended to, and I hope I will be able to get back.

Gentlemen, thank you very much for being here.

Senator DODD. Thank you very much, Senator Wirth.

Let me turn to Senator Sasser and then Senator D'Amato.

Senator Sasser.

OPENING STATEMENT OF SENATOR SASSER

Senator SASSER. Thank you, Mr. Chairman.

I will welcome our distinguished witnesses here today. I want to compliment you, Mr. Chairman, for convening these hearings and also compliment you on the legislation that you have introduced.

You know, we often forget Black Monday. I am always amazed at the ability of the human mind to suppress thoughts from the past that aren't particularly pleasant, and I think we have done a pretty good job of repressing Black Monday. It seems like it happened 30 years ago rather than just a couple of years ago, yet looking back, Mr. Chairman, I am not sure what changes have been made in the markets to prevent a similar shock from occurring once again.

I know one thing. Congress has certainly not acted, at least so far, and I want to say that I was particularly concerned during that whole unhappy episode about the treatment of the small investors in the stock market crash, and I am concerned about whether this treatment could take place again.

I think we need some framework in place to assure that small investors can get a fair shake, or else they may never return to the markets to the degree that the economy actually needs.

In the final analysis, that is what the stock market is all about. It is not there just simply to make money for traders, brokers, et cetera. The reason for being for the stock market is to supply the capital that this economy and the great corporations of this nation need, and I think individual investors were trampled by the institutional traders on Black Monday. Individual traders found that their trades were executed last, if they were executed at all, yet these same individuals are the ones who are the long-term investors. They are the stockholders that our American companies really need if they are going to be able to make long-term investments, particularly in the field of research and development, where we see our American corporations falling behind.

So, Mr. Chairman, I have become increasingly concerned about the degree to which corporate equity is owned by huge monolithic institutions. It seems that the markets are increasingly driven by analysts sitting there behind computers that hold huge blocks of stock for only hours at a time, and that is hardly a sound basis, I would submit, for our economy.

In closing, I want to note, Mr. Chairman, the work that you did just this past week in the Budget Committee in getting the funding for the Securities and Exchange Commission up to the appropriate level, and I was pleased to work with you in that endeavor. The SEC has been underfunded throughout the 1980's at a time when volume and complexity in the markets has increased enormously.

I think the additional funding provided in the fiscal year 1990 budget resolution, an 18 percent increase over 1989, at a time of great fiscal austerity should help the SEC get an even better handle on the situation.

Mr. Chairman, I look forward to the testimony of our distinguished witnesses today.

Thank you.

Senator DODD. Thank you, Senator Sasser.

Let me just quickly note that that budget increase for the SEC could not come at a more important time. Certainly, Chairman Ruder and members of the Commission and at least the staff, when you consider the workload they are asked to carry, that increase is extremely important, and we are really very thankful to you and other members of the Budget Committee for moving forward with that. It is extremely important.

Senator D'Amato.

Senator D'AMATO. Mr. Chairman, I am going to ask in the interest of time that my full statement be accepted into the record as if read in its entirety.

Senator DODD. Without objection. I also have a statement from Senator Sanford to be inserted in the record.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Mr. Chairman, as we consider legislation aimed at responding to the October, 1987 market crash, we can observe that some remarkable things have and have not occurred since October, 1987. First, despite the panicked predictions of lost confidence and the flight of foreign securities investors, the growth of the American economy has continued without a hitch. Indeed, major action by the Federal Reserve has been necessary to keep the economy from running beyond capacity. This is hardly the type of result that would bear out the dire predictions of the post-cash doomsayers.

Second, despite many studies and proposals, no legislative action has, to date, dealt with the supposed causes of the October crash. Instead, the securities industry and the exchanges have instituted many changes both regulatory and technological. These changes appear to go a long way toward addressing the cause of the last crash. The question remaining for us is what in addition must we do to prevent another crash.

As you know, Mr. Chairman, none of these improvements have been tested under game conditions. Therefore, little is known whether these improvements will work and, indeed, no evidence exists to even prove that these mechanisms are the right types of reforms to address the problems of October, 1987. However, they appear to be the best ideas that our best minds can deliver.

Additionally, since 1987, we have seen some unfortunate and dratatic changes in the shape of the industry. The securities industry has lost over 25,000 jobs since the October crash. Many of these lost jobs are caused by the continued absence of the individual investor from the securities markets. Many individual investors may have taken the money they once invested in stocks through a broker and moved it into mutual funds. This money remains in the capital markets and remains available for productive investment. However, others have simply left the stock market.

Whether the loss of the individual investor is permanent is an important question. Some say that the individual investor has left the stock market because the market has become a pro's game. Perhaps we should look to the question of whether this is true and, if so, is this a good thing.

In any case it is good to return to these matters to assess what progress has been made has been made in improving both the facts and the preceptions of the securities markets.

OPENING STATEMENT OF SENATOR TERRY SANFORD

Senator SANFORD. Thank you, Mr. Chairman. I would like to welcome our distinguished panel of witnesses back before the committee and to thank them for their very helpful testimony. It seems hard to believe that it was over 18 months ago that this committee met for numerous hearings to examine the aftermath of October 19 and its implications for our securities, options and futures markets. We are all encouraged by the steps that the organizations represented today have taken to heed the advice of the Brady Commission and many of the other reports issued following the crash of last October.

Indeed, I want to commend the work that you have done in that time to address some of the problems that arose during those fateful days in October 1987. We realize that you and your organizations have spent considerable time, money and effort to address many of inequities and difficulties pointed out in the numerous post-crash analyses. I think your efforts to bring about coordinated circuit breakers and to improve inter-exchange information flows are to be commended. And the efforts to ensure that the small investor is not prejudiced in having his or her order executed on the stock exchanges also deserve our support and thanks.

However, I must say that despite the time that has passed and the steps that have been take since October 1987, I remain somewhat concerned both about the condition of the market and the lack of steps that have been taken in some areas to ensure that another October 19 does not recur. While I commend the Self-Regulatory Organizations for their efforts to bring about coordination, I remain concerned that our regulators do not have a well-formulated "crisis" plan in place for addressing any future market breaks.

In addition, one of the key issues to emerge as a significant problem in the Brady Commission and other analyses is the need for greater coordination in the clearance and settlement area, yet little has been accomplished in this area. Other areas, such as a possible need for greater "harmonization" of margins has not been entirely worked out and margins in the futures area have, in some instances, lowered below pre-crash levels.

Following the October crash, many looked in hindsight and said the crash was bound to happen given the tremendous overheating of the market. Yet here we are 19 months later with the Dow Jones at the same point that it was on Wednesday, October 14, just 3 trading days before Black Monday. If the market was overvalued in October of 1987, should we be concerned about its levels today?

In addition, one of the key concerns emerging from the post-crash reports focused on program trading and its potential for bringing much greater volatility to the market—volatility which may still be scaring off individual investors. I wonder whether the underlying concerns about progam trading are still as valid today as they were in October of 1987 and if so, what should we be doing about them?

In looking at this morning's *Wall Street Journal*, I am reminded of the degree to which the small investor has remained on the sidelines. I think we all should examine why small investors and indeed, institutional equity investors, have not felt entirely confident about the securities markets. If our capital markets are to continue their main function—to raise private capital for investment in corporations throughout this country—then both small and large investors must have a greater degree of confidence that our markets are fair and efficient. I look forward to hearing the suggestions of our witnesses of steps that should be taken to help shore up confidence in the market.

Finally, I remain equally concerned about the issue of frontrunning. I was pleased to note the concern of some of our witnesses that more attention needs to be focused on concrete steps that can be taken to further curb frontrunning. I hope that all involved can move quickly to stop frontrunning, as I believe it is one of the factors contributing to the sense that small investors have that the markets are not entirely fair.

I commend our Chairman, Senator Dodd, and our ranking member, Senator Heinz, for stepping forward with the SEC's recommended legislation to address large trader reporting, the need for the SEC to halt trading in certain emergency circumstances, greater risk assessment capabilities for holding company system's, and the need, as I mentioned, for more coordinated clearing and settlement. I look forward to hearing your comments on those proposals and to working with you to iron out any difficulties you may have with that legislation as we move forward to give the SEC some of the tools it needs to address continuing problems in our capital markets.

Thank you, Mr. Chairman.

I, too, have another hearing on defense appropriations and will have to leave. I certainly commend you, Mr. Chairman, and welcome our distinguished witnesses and panelists.

It seems to me, Mr. Chairman, that S. 658, the legislation being considered, which you are putting forth, is well-grounded It gives to the SEC the emergency authority to independently shut down securities markets for no longer than 24 hours, authorizes them to require all broker/dealers to report the absolute trading, the so-called large trades. I think that is important. It authorizes the SEC to review information on the financial soundness of the entire holding company that owns a securities affiliate, and that is important.

It authorizes the SEC, the CFTC, and the Fed to coordinate to ensure better transaction clearance procedures, as we have heard in the past how that is so very, very important.

Mr. Chairman, let me commend you for your stewardship of this subcommittee in ensuring the integrity of the marketplace and hopefully making it one where the small investor, as Senator Sasser has indicated, has confidence restored, and hopefully we can see it return with more confidence and more people becoming involved.

I thank the Chairman for his courtesy.

[Copy of prepared bill S. 648 follows:]

II

101st CONGRESS
1st Session

S. 648

To amend the Securities Exchange Act of 1934.

IN THE SENATE OF THE UNITED STATES

March 17 (legislative day, January 3), 1989

Mr. Dodd (for himself and Mr. Heinz) (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing and Urban Affairs

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A BILL

To amend the Securities Exchange Act of 1934.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Market Reform Act of 1989".

SEC. 2. EMERGENCY AUTHORITY; TRADING HALTS.

Section 12 of the Securities Exchange Act of 1934 (12 U.S.C. 78l) is amended by adding at the end the following:

"(m)(1) The Commission, in an emergency, may by order summarily take such action to alter, supplement, suspend, or impose requirements or restrictions with respect to any matter or action subject to regulation by the Commission or a self-regulatory organization under this title, as the Commission determines is necessary in the public interest and for the protection of investors to maintain or restore fair and orderly securities markets (other than markets in exempted securities) or to ensure prompt and accurate clearance and settlement of transactions in securities (other than exempted securities). An order of the Commission under this paragraph shall continue in effect for the period specified by the Commission, and may be extended, except that in no event shall the Commission's action continue in effect for more than 10 business days, including extensions. In exercising its authority under this paragraph, the Commission shall not be required to comply with the provisions of section 553 of title 5, United States Code, or with the provisions of section 19(c) of this title.

"(2) In the exercise of its emergency powers pursuant to paragraph (1) of this subsection, the Commission is authorized to suspend summarily all trading in any or all securities (other than exempted securities) on any national securities exchange or otherwise for such period specified by the Commission, or until such time as the Commission authorizes the resumption of trading, but not for more than 24 hours. The Commission, with the approval of the President, may determine to extend such suspension for not more than two additional 24-hour periods.

"(3) The President may direct that emergency action taken by the Commission under paragraph (1) or (2) of this subsection shall not continue in effect.

"(4) For purpose of this subsection, the term 'emergency' means a major market disturbance characterized by, or constituting—

"(A) a substantial threat of sudden and excessive fluctuations of securities prices generally that threaten fair and orderly markets, or

"(B) a substantial disruption of the safe or efficient operation of the national system for clearance and settlement of securities.

"(5) No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security in contravention of an order entered by the Commission under this subsection unless such order has been stayed, modified, or set aside as provided in paragraph (6) of this subsection.

"(6) Any action taken by the Commission pursuant to this subsection shall be subject to review only as provided in section 25(a) of this title. Review shall be based on an examination of all the information before the Commission at the time such action was taken. The reviewing court shall not enter a stay, writ of mandamus, or similar relief unless the court finds, after notice and hearing before a panel of the court, that the Commission's action is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.".

SEC. 3. LARGE TRADER REPORTING.

Section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m) is amended by adding at the end the following:

"(h)(1) For the purpose of monitoring the impact on the securities markets of securities transactions involving a substantial volume or a large fair market value or exercise value, and related transactions in equity index futures and options on such futures, every person who, for his own account or an account for which he exercises investment discretion, effects—

"(A) transactions for the purchase or sale of any publicly traded securities or options, or

"(B) transactions in contracts of sale (or options on such contracts) for future delivery of a group or index of publicly traded securities (or any interest therein or based on the value thereof) that are related to transactions in publicly traded securities or options,

by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of a national securities exchange or board of trade, during any 24-hour period in an amount equal to or in excess of such amount as shall be fixed from time to time by the Commission, shall file reports regarding such transactions with the Commission, or any self-regulatory organization as the Commission shall designate by rule, regulation, or order to receive such reports. Reports required under this subsection shall be filed at such times, and include such information with respect to any transaction or series of transactions subject to this subsection, as the Commission, by rule, regulation, or order may prescribe.

"(2) For purposes of this subsection—

"(A) the term 'publicly traded securities or options' means any equity securities, including options on individual equity securities, and options on a group or index of such securities, listed, or admitted to unlisted trading privileges, on a national securities exchange, or quoted in an automated interdealer quotation system;

"(B) two or more persons acting as a partnership, limited partnership, syndicate, or other group, for the purpose of effecting transactions described in paragraph (1) of this subsection, shall be deemed a 'person'.

"(3) The Commission may prescribe rules governing the manner in which transactions and accounts shall be aggregated for the purpose of paragraph (1) of this subsection.

"(4) Notwithstanding the provisions of section 552 of title 5, United States Code, or of any other law, the Commission shall not be compelled to disclose any information required to be reported under this subsection. Nothing in this subsection shall prevent the Commission from complying with a request for information from a duly authorized committee or subcommittee of the Congress or complying with an order of a court of the United States in an action commenced by the United States or the Commission.

"(5) The Commission, by rule, regulation, or order, may exempt any person or classes of persons or any transaction or classes of transactions, either conditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection, and the rules and regulations thereunder.".

SEC. 4. RISK ASSESSMENT FOR HOLDING COMPANY SYSTEMS.

Section 17 of the Securities Exchange Act of 1934 (15 U.S.C. 78q), is amended by adding at the end the following:

"(h)(1) For the purpose of monitoring the financial and operational condition of persons subject to this section, and to provide greater protection for investors, every person who is (A) a registered broker or dealer, or (B) a government securities broker, or government securities dealer, for which the Commission is the appropriate regulatory agency, shall make such reports as the Commission, by rule, regulation, or order prescribes concerning any aspect of the financial or operational condition of its associated persons, other than a natural person, that the Commission determines is reasonably likely to have a material impact on the financial or operational condition of such registered broker or dealer, government securities broker, government securities dealer, or municipal securities dealer. Reports prescribed by the Commission under this section may include, but shall not be limited to, information concerning assets, liabilities, contingent liabilities, material contracts, loan commitments, trading or investment positions, lines of credit, letters of credit, and financial guarantees.

"(2) No information shall be required of any person subject to paragraph (1) of this subsection regarding any associated person that is—

"(A) a financial institution as defined in section 3(a)(46) of this title;

"(B) a bank holding company, as defined in section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a));

"(C) a savings and loan holding company, as defined in section 408(a)(1)(D) of the National Housing Act (12 U.S.C. 1730a(a)(1)(D));

"(D) an insurance company, as defined in section 2(13) of the Securities Act of 1933 (15 U.S.C. 77b(13)); or

"(E) a futures commission merchant or introducing broker as defined in section 2(a)(1)(A) of the Commodity Exchange Act (7 U.S.C. 2);

if information substantially similar to that required to be included in reports under paragraph (1) of this subsection is available to a supervisory agency, as defined in section 1101(6) of the Right to Financial Privacy Act of 1978 (12 U.S.C. 3401(6)), a State insurance commission, or similar State agency, or the Commodity Futures Trading Commission.

"(3) The Commission, by rule, regulation, or order, may exempt any person or classes of persons, or any transaction or classes of transactions, either conditionally or upon specified terms and conditions or for stated periods, from the provisions of this subsection, and the rules and regulations thereunder. In granting such exemptions, the Commission shall consider, among other factors, the primary business of any associated person, the nature and extent of domestic or foreign regulation of the associated person's activities and, with respect to the person required to report pursuant to this subsection and its associated persons, on a consolidated basis, the proportion of assets devoted to, and revenues derived from, activities in the United States financial markets.

"(4) Notwithstanding the provisions of section 552 of title 5, United States Code, or of any other law, the Commission shall not be compelled to disclose any information required to be reported under this subsection. Nothing in this subsection shall prevent the Commission from complying with a request for information from a duly authorized committee or subcommittee of the Congress or complying with an order of a court of the United States in an action commenced by the United States or the Commission.".

SEC. 5. COORDINATED CLEARING.

(a) Section 17A(a)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78q-1(a)(1)) is amended by adding at the end the following:

"(E)(i) The clearance and settlement systems for transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options are integrally related.

"(ii) The absence of links or coordination among clearing facilities for transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options may impose unnecessary costs and add unnecessary liquidity demands to the nation's financial systems.".

(b) Section 17A(a)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78q-1(a)(2)) is amended to read as follows:

"(2)(A) The Commission is directed, therefore, having due regard for the public interest, the protection of investors, the safeguarding of securities and funds, and maintenance of fair competition among brokers and dealers, clearing agencies, and transfer agents, to use its authority under this title—

"(i) to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities (other than exempted securities); and

"(ii) to facilitate the establishment of linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options in accordance with the findings and to carry out the objectives set forth in paragraph (1) of this subsection. The Commission shall use its authority under this title to assure equal regulation under this title of registered clearing agencies and registered transfer agents. In carrying out its responsibilities set forth in clause (ii) of this subparagraph, the Commission shall consult with the Commodity Futures Trading Commission and the Board of Governors of the Federal Reserve System.

"(B) The Securities and Exchange Commission and the Commodity Futures Trading Commission, in consultation with the Board of Governors of the Federal Reserve System, shall examine progress toward establishing linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options, and shall submit to Congress, not later than 2 years from the date of enactment of this provision, a report detailing and evaluating such progress.".

(c) Section 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78q–1) is amended by adding at the end the following:

"(f) In order to promote prompt and accurate clearance and settlement of securities transactions, notwithstanding any provision of State law, the Commission is authorized to adopt rules concerning the transfer of certificated or uncertificated securities or limited interests (including security interests) therein (but is not authorized to adopt rules concerning the transfer of securities or limited interests (including security interests) therein with respect to government securities issued pursuant to chapter 31 of title 31, United States Code, or securities otherwise processed within a book-entry system operated by the Federal Reserve Banks) if the Commission finds that, in the absence of such rules, the safe and efficient operation of the national system for clearance and settlement of securities transactions is substantially impeded. In exercising its authority under this subsection, the Commission shall consult with the Secretary of the Treasury.".

(d)(1) Section 5 of the Commodity Exchange Act (7 U.S.C. 22) is amended by adding at the end the following:

"(c)(1) The Congress finds that:

"(A) Commodity clearing organizations play a vital role in the functioning of contract markets and in ensuring the financial integrity of the marketplace in which transactions are executed.

"(B) The clearance and settlement systems for securities, securities options, contracts of sale for future delivery and options thereon, and commodity options are integrally related.

"(C) The absence of links or coordination among clearing facilities for contracts of sale for future delivery and options thereon, commodity options, securities, and securities options may impose unnecessary costs and add unnecessary liquidity demands to the Nation's financial systems.

"(2) The Commission is directed, therefore, having due regard for the public interest and maintenance of fair competition among contract markets, commodities and futures clearing organizations, members thereof, and futures commission merchants, to use its authority under this Act to facilitate the establishment of linked, coordinated, or centralized facilities for clearance and settlement of contracts of sale for future delivery and options thereon, commodity options, securities, and securities options, in accordance with the findings set forth in paragraph (1). In carrying out its responsibilities set forth in this paragraph, the Commission shall consult with the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System.".

(3) The Commodity Futures Trading Commission and the Securities and Exchange Commission, in consultation with the Board of Governors of the Federal Reserve System, shall examine progress toward establishing linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options, and shall submit to Congress, not later than 2 years from the date of enactment of this subsection, a report detailing and evaluating such progress.

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Senator DODD. Thank you, Senator D'Amato, for your comments as well.

I think the key word is "confidence." Whether it is from Senator Phil Gramm's point of view from Texas or our colleagues, Senator Riegle and Senator Wirth, the issue is confidence. I think that is what we are all interested in and how best to achieve that and simultaneously encourage future capital markets.

We thank all of our witnesses for being here. Of course, they are well-known to all of us. John Phelan is the Chairman and Chief Executive Officer of the New York Stock Exchange. Joe Hardiman is the President of the National Association of Securities Dealers. And Leo Melamed is Chairman of the Executive Committee of the Chicago Mercantile Exchange.

We thank all of you for joining us here this morning. I will ask each of you to proceed in the order that I have introduced you.

For the sake of time, your testimony is lengthy, and understandably so, but in a couple of cases you have provided synopses and brief summaries of your comments. Your complete testimony of course will be a part of the record, but in the interest of time, if you might go through the major points that we have raised here and we have asked you to address this morning, I would appreciate it very much.

We will begin with you, John. Thanks for being with us.

STATEMENT OF JOHN PHELAN, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, NEW YORK STOCK EXCHANGE, NEW YORK, NY

Mr. PHELAN. Thank you, Mr. Chairman. I suppose I should also add a few comments.

I am not reporting today that we have entered the Elysian Fields and we can lie in the tall grass, smell the flowers, and drink ambrosia, but I want to thank Congrees in general and this committee in particular for allowing each of the market centers to act on our own. We have taken the Brady and the SEC studies and we have done our own studies, and at least internally have been able to upgrade and report to you on our progress and I want to thank you for your patience and forbearance in letting us do that.

Externally, I don't think we have ever had better cooperation between the markets, the three participants that sit at this table, between ourselves, and the NASD and between the futures and the options markets. It has been that kind of cooperation that has allowed us to put in the circuit breakers, to allow us to put in the emergency mechanisms.

About a month or so ago, we came reasonably close to putting in place the Standard & Poor's limit. We didn't reach that point in time, but everything was working properly. Everybody was talking together, and I think we constantly go through dress rehearsals for things like that, and from my observation, although the Working group perhaps has not met, at least we have individually continued to talk to all of them. They are aware of what we are doing. They seem to be, I think, satisfied in that area as well.

So I think that while they may not have had an official meeting, they certainly have been in touch and have kept in touch and understand what we are doing, what we are about, and hopefully have approved of that as well.

Internally, I think we have improved our systems that we have talked about, and I think we have spent a lot of time trying to make 600 million shares look as though, at least from a systems point of view, there has been 200 million shares. We have got a whole new system at the Exchange and the member firms. We have hired outside people to help us, Peat Marwick and A.D. Little, and all those things and the cooperation among all the industry people seems to be going well, indeed.

On the individual investor side, which I think is all of our concern, we can come back later as to why we think the individual has not reentered the market and, indeed, the institutions have not reentered the market, at least with new money. We have put in an express routing system for all individual investors. Once the market goes up or down 25 points those orders are so marked by the member firm community and they come through an express route and go to the head of the line for execution.

We have set up an individual investor advisory committee, which gives us more input from that very important constituency.

I think we need to continually work on our market for fairness and equal access by everybody, whether you have a hundred shares or a million shares to execute.

On the regulatory side, we strengthened the specialists' capital requirements. We have done a number of things in depth guidelines. We have made a significant commitment to enforcement and to member firm examination, as well as surveillance, and we continue to upgrade those things as well.

On the legislative side, the proposed legislation, I think that you see in our testimony that we certainly support the emergency authority for the SEC. We think they should have that. I do not think that they would ever do anything without consulting the markets anyway.

We have always had good communication with them when we have had a crisis, either in an individual stock or in the market as a whole; and indeed, our cooperation with them in October of 1987 certainly leads me to believe that there will not be any change in that.

On large trader reporting, we have sent two questionnaires out to our member firms. There are, I think, some legitimate concerns about large trader reporting. We have come to the conclusion that we cannot do it in our market alone. If it is going to be done, it has to be done across all markets, and really the Commission would have to do that.

I think, given the concerns of member firms, particularly about proprietary trading, and particularly about how new products are coming out—they are afraid that their competitors will understand what they are doing—that it might be possible to keep those files within the firms themselves; and then, for specific regulatory reasons they are requested by the SROs or the regulators.

Those regulatory reasons might be the reconstruction of the markets in October 1987, or for insider trading manipulation, or something like that.

Risk assessment for holding companies is another area in which a lot of new products and innovations are being done. I think again there is a concern by the firms that their competitors will understand how they are treating new products, and how they are finding new initiatives in the market.

We certainly do not look to regulate holding companies; yet it seems to me, because of all the innovation and all the risks that are being taken there, that somebody should at least have some idea of the systemic risks that may evolve out of these new things, both domestically and worldwide. If we are going to do that, it seems to me that the Commission is the one to do that.

On coordinated clearing and settlement, we certainly think that more needs to be done in this area. Everybody talks about a lot of studies, but one of the things that needs to be done is to really get a good understanding of all the clearance and settlement facilities in the United States, how they interact with one another, how they interact with the Fed, what are their strengths, and what kinds of changes or recommendations might be made in the light of what happened in the past and what we see in the future.

There is an interface there between not-for-profit clearing corporations and for-profit, and I think that has to be taken into consideration as well.

Then, it would seem to me that somebody like the Working Group, who represents the Federal Reserve Board, the Treasury, the CFTC and the SEC, would be the likely people to do that, because they represent all the participants.

More importantly, and I am sure you want to get to it later on, is the Group of 30 recommendations. We need eventually to make sure that the firms are not only strong, but that they are linked officially with the rest of the world, and what are the risk assessments.

There are two big studies coming out of that which are extremely important. One, how do we make sure that the clearance and settlement systems are working in this country the way we want them to? And secondly, how are they linked up with the rest of the world?

Lastly, I would say that nobody can ever assure anybody that we will not have another major correction of the market. Indeed, the market is a continuing succession of problems; but we hope we can handle them efficiently.

I think a lot has been done at the Exchange. We have taken every major suggestion by Brady or the SEC and tried to implement it in some way, based on what we have learned in October 1987, to strengthen our own markets and to work with all other market participants in the country to strengthen the entire system.

I want to thank you for the opportunity to testify.

[The complete statement of John Phelan follows:]

SUMMARY OF TESTIMONY BY JOHN J. PHELAN, JR.
CHAIRMAN AND CHIEF EXECUTIVE OFFICER, THE NEW YORK STOCK EXCHANGE
TO THE SENATE BANKING COMMITTEE SECURITIES SUBCOMMITTEE
MAY 18, 1989

My testimony covers three principal areas, namely, the philosophy and strengths of the New York Stock Exchange market system; the broad array of initiatives instituted by the NYSE since the October 1987 market break; and comments on S. 648, the proposed Market Reform Act of 1989.

THE NYSE MARKET SYSTEM

The fundamental principle underlying the NYSE market system is that the public interest should always come first. The NYSE implements this by designing operational and regulatory systems that emphasize fairness, openness, liquidity and direct interaction between public buyers and sellers of securities.

The basic strength of the system is derived from the diversity of its participants and the fact that no one group dominates the market. The principal participants are:

- Individual investors and institutional investors
- Member firms functioning as both agents and dealers
- Member-firm brokers acting as agents on the trading floor and representing the firms' customer orders
- Independent brokers on the trading floor handling customer orders on behalf of other member firms
- Dealers with assigned responsibility in individual securities on the trading floor known as specialists.

The unique interaction among these individual and institutional investors, specialists and the other trading professionals results in the enormous liquidity of the NYSE market system which none of the participating groups alone could provide.

This interaction also creates the most efficient pricing mechanism, one in which the price of a stock is established by public orders competing with each other. NYSE trading rules promote this direct interaction of public orders; and assigned dealers, or specialists, can neither dominate the market nor set the price in any stock.

Paralleling the operational system, the NYSE's expanding regulatory and market surveillance efforts, in conjunction with the SEC, underscore its commitment to operating the fairest possible market.

Besides its emphasis on fairness, liquidity, and direct interaction between public orders, a fourth way in which the NYSE market system supports the public interest is its openness. All trades are reported and publicized as they occur, with the price and volume of every trade on the NYSE floor recorded in a matter of seconds on our Consolidated Tape -- thus providing an immediate report and a continuous record for investors.

INITIATIVES DESIGNED TO REINFORCE THE NYSE MARKET SYSTEM

During the past 19 months the NYSE has redoubled its efforts to reinforce the NYSE market system with nearly 30 initiatives that have enhanced intermarket cooperation, operational and regulatory capability, supporting technology, and interaction with NYSE's varied constituents.

These major initiatives have been undertaken by the NYSE:

- Launching the Individual Investor Express Delivery Service, which gives transmission priority to the small orders of individual investors during unusually active markets
- Agreement with the Chicago Mercantile Exchange to take specified, temporary actions when the price on the Standard and Poor's 500 futures contract traded on the CME declines 12 points
- Establishment of coordinated circuit breakers, in which all U.S. equities, options and futures markets will suspend trading for limited periods of time in cases of excessive market volatility
- Creation of an inter-exchange hotline to share information on an ongoing basis and to coordinate action during crises with all stock, options and futures exchanges and the NASD
- Technological upgrades which have averaged one per month since October 1987 and cover everything from the NYSE Consolidated Tape to behind-the-scenes processing systems
- Building capacity so the NYSE can manage 600 million shares a day as efficiently as it already processes 200 million, and in the early 1990s handle peak, one-day demand of 1 billion shares a day
- Implementing a broad program to increase the NYSE's regulatory and market surveillance capabilities, its monitoring of sales practices, and its specialists' standards and requirements
- Insuring the NYSE stays attuned to the changing needs of its constituents by creating four new advisory committees to its board of directors on individual investors, pension managers, regulatory matters and Japan.

All these measures -- as well as many others -- contribute to the strengthening of the securities marketplace and its regulation.

PROPOSED LEGISLATION

The NYSE has given careful consideration to each of the four sections of S. 648, the proposed Market Reform Act of 1989.

SEC Emergency Authority and Trading Halts

Based on its experience during the week of October 19, 1987, the NYSE supports providing the SEC with authority to halt securities trading under the circumstances spelled out in the legislation.

The NYSE hopes that the SEC will consult with the NYSE and other self-regulatory organizations before exercising this authority.

Large Trader Reporting

After surveying its member firms, the NYSE concluded that large trader reporting should be done through the SEC and reach across all markets. To meet legitimate concerns about unwarranted disclosure, the data could be compiled in a member firm's file and disclosed on request to an SRO or regulator. Rules should limit requests to narrowly defined purposes such as insider trading investigations or reconstruction of the market following an event like October 19, 1987. Inconsistencies in disclosure and audit trail practices between U.S. and foreign markets will affect international investors and could make enforcement difficult.

Risk Assessment for Holding Company Systems

The NYSE does not want to regulate holding companies, but it believes some agency such as the SEC should gather sufficient data to assess the financial soundness of holding companies that are parent companies of broker-dealers. As financial institutions enter non-traditional businesses not subject to self-regulatory oversight, they have the potential to create systemic risks domestically and internationally.

Coordinated Clearing and Settlement

The NYSE agrees that the clearance and settlement system for securities should be strengthened, and that clearance and settlement of securities and securities derivative products should be coordinated. But here again, a distinguished international private-sector financial body, The Group of Thirty, has pointed out the threats of national and international systemic risk involving even regulated entities.

CONCLUSION

For nearly 200 years the NYSE market system has been a leading force in the capital-raising and asset-allocation process that has been the bulwark of the U.S. economy. All the comprehensive measures taken by the NYSE over the past year-and-a-half to strengthen the system, coupled with the NYSE's traditional vigilance, will help maintain the Exchange's strong position and its contribution to the U.S. and world economy into the next century.

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Mister Chairman and Members of the Subcommittee.

I'm delighted to be here. I would like, today, to give you a description of our market, as well as what we've done since the October 1987 market break.

I also would like to comment on several legislative proposals recommended by the Securities and Exchange Commission and introduced by you, Mister Chairman, and Senator Heinz.

Let me begin by giving you a brief background of the New York Stock Exchange.

The NYSE has a varied and broad-based constituency made up of some 500 member firms, over 1,700 listed companies, more than 10,000 institutional investors, and nearly 83,000 active Registered Representatives.

In terms of the investing public there were, at last count, about 47 million Americans who were direct shareowners in America's corporations -- 70 percent of whom hold NYSE listed stock -- while 47 percent held only NYSE listed stock.

According to the latest figures, an estimated 140 million additional people were reported as indirect shareowners through insurance companies and pension funds, for a total of 187 million direct and indirect shareholders, all of whom have a common interest in preserving the fairness and orderliness of our equities markets.

In other words, the NYSE is a market with many constituencies and deeply planted roots in the American economy.

Working with, and on behalf of our multiple constituencies, the role of the NYSE is to:

. Promote the capital-raising process by maintaining an open, fair and liquid marketplace under normal conditions for the issuance and trading of securities.

. Provide investors -- large and small -- with a vehicle for managing their assets through investment.

. And promote effective self-regulation of the market and market participants for the protection of investors and the integrity of the marketplace.

Underlying this role is the fundamental philosophy of the NYSE market system, which is to provide investors -- to the greatest degree possible -- maximum fairness, openness, liquidity and direct interaction between public buyers and sellers of securities.

Our ability to accomplish these goals stems from the way the NYSE operates and from the interplay among the NYSE market system's broad array of participants.

In addition to individual investors and institutional investors, these participants include member firms functioning as both agents and dealers, member-firm brokers acting as agents on the trading floor and representing the firms' customer orders, independent brokers on the trading floor handling customer orders on behalf of other member firms, and dealers with assigned responsibility in individual securities on the trading floor, also known as specialists.

Let's take a closer look at the key professional participants who play such vital roles in the NYSE market system.

THE KEY PROFESSIONAL PARTICIPANTS IN THE NYSE MARKET SYSTEM

NYSE member firms are an integral part of the NYSE market system, including the broker-dealer organizations that serve the investing public. These firms are represented on the trading floor by brokers who serve as fiduciaries in the execution of customer orders. These brokers use their knowledge, experience, judgment and trading skills to represent orders the firms send to the NYSE marketplace to be executed for customers.

Independent brokers perform the same fiduciary task for firms without their own trading floor representatives. They also serve as an extension of the member firms' network of trading brokers.

Another key professional in the NYSE market system is the "upstairs trader," who works at a member-firm trading desk and is linked through sophisticated communications systems to the NYSE trading floor, as well as to other markets. Representing the public, or their own firms, these traders commit capital to facilitate block orders for customers, engage in arbitrage between the equities markets and derivative products markets, and conduct proprietary trading, or trading for their firms' own accounts.

The final group of trading professionals -- the assigned dealers, or specialists -- operate in conjunction with all the other market participants. They are responsible for helping maintain fair and orderly markets in the securities assigned them.

They do this in four different ways:

- As dealers they trade for their own accounts when there is a temporary absence of public buyers or sellers, but only after public orders at specific prices which are in their possession have been satisfied at those prices.
- As agents, they execute orders entrusted to them by brokers, as well as orders awaiting a specific market price.
- As catalysts, they help to bring buyers and sellers together.
- And as auctioneers, they quote current buy and sell orders that reflect total supply and demand for each of the stocks assigned to them.

As a guide for specialists in the performance of their duties, we have developed the NYSE specialist job description (Attachment 1), which was revised three months ago to make these guidelines more specific.

In addition, our specialists are rated four times a year by their customers -- 20-to-30 of the more active brokers handling their stocks -- through the Specialist Performance Evaluation Questionnaire, which not only is used to measure performance by assigned dealers and provide a basis for ongoing improvement. The results are used by our Allocation Committee in determining who will get new listings.

We also monitor performance of assigned dealers by their ability to help maintain market continuity and depth.

Continuity reflects change in price from one trade to the next. The more liquid the stock, the more it trades at minimal price variations. Market depth extends the concept of reflecting price movement to a sequence of trades for a specific amount of shares. The more liquid the stock, the smaller the price movement over the fixed amount of shares traded, and the better the depth of the market.

As part of our continuing efforts to make our assigned dealers perform at even higher standards, and also to reflect the continued emphasis we put on market depth, we have upgraded our depth standards from 1,000-share sequences to 3,000-share sequences. We plan further experiments with higher levels in the future.

In carrying out their functions and interacting with all the other components of the market, assigned dealers are required to provide expert leadership, helping to maintain smooth and continuous trading throughout the day.

This leadership role for assigned dealers requires them to use their own capital to buy and sell stock when it is needed to help maintain a fair and orderly market.

Assigned dealers cannot put their own interests ahead of public orders, and are obligated to trade for their accounts against the market trend to help maintain liquidity and continuity as the price of a stock goes up or down. They do not set the price of a stock on the NYSE; it is established by public orders competing with each other.

The fundamental principle of the NYSE market system is that the public interest should always come first. While the basic strength of the system is derived from the diversity of its participants, no one group of participants dominates the market. Instead, all the professional components must -- and do -- subordinate their interests to those of public customers.

The enormous liquidity and basic strength of the NYSE market system stems from the active involvement of all the participating groups -- individual and institutional investors as well as member firms and assigned dealers.

And as demonstrated by October 19th, 1987, no one of them alone can maintain the level of liquidity in the market provided by all.

On that day, three of the the four major participants -- the individual investor, institutional investor and the member firm -- either were out of the market or were on the sell side -- leaving just one participant, the specialist.

The tough standards we had set for our specialists paid off on October 19th when, despite their overwhelming predicament, they performed well.

The SEC, in its report on the market break, said, "Although there were some instances of questionable performance...specialists as a whole met their market-making obligations."

Following are some of the ways they met those obligations:

. Even though the Dow Jones Industrial Average dropped more than 500 points on that fateful day, NYSE stocks traded unchanged from, or within one-eighth of a point of, the price of the previous trade 73 percent of the time.

. On October 19th, specialists, or assigned dealers, intervened in the market nearly 18 percent of the time -- instead of the normal 10 percent -- to make purchases and sales for their own accounts, in an effort to maintain orderly markets under very difficult circumstances

. On the same day, assigned dealers traded against the market trend in 94 percent of their trades for the purpose of bringing balance to the market -- compared with an average of 88 percent.

Following the events of October 1987, we took additional measures to strengthen our assigned dealers.

We raised the minimum capital requirement for our assigned dealers tenfold to $1 million and tripled the minimum share position they must be able to maintain for each stock assigned to them to 15,000.

And, based on inadequate performance by a few assigned dealers during the October 1987 market break, we have reallocated eleven stocks -- or one-half of one percent of all stocks issued on the NYSE -- to other assigned dealers.

These steps reinforce the entire NYSE market system, which is the most efficient securities pricing mechanism in existence, and help maintain a level of liquidity that is possible only with such a breadth of public participation and professional expertise.

In addition to maintaining maximum public interaction, fairness and liquidity, the NYSE believes in openness, and operates in the sunshine as much as possible. All trades are reported and publicized as they occur, with the price and volume of every trade on the NYSE floor recorded in a matter of seconds on our Consolidated Tape, thus providing an immediate report and a continuous record for investors.

This means our last sales are not imputed, but are actual, real times of sale; and they are not estimated within a certain period.

That puts enormous discipline on our system. It means that our institutional and member-firm trading desks, as well as the brokers executing the order have a check throughout our system on every sale of every trading day, whether or not the trading professional actually participated in the order. This also serves as an added check on our assigned dealers. And it is, in fact, the best kind of regulator.

As a result any investor, individual or institutional, can participate in the NYSE market system at any time during the trading day and know exactly what is taking place. The individual investor anywhere in the country can talk to his registered representative or broker and know exactly what is going on at that time.

This is not necessarily the case in all markets around the world. London's stock exchange, for example, has introduced a controversial rule under which the prices of large trades in its leading -- or "alpha" -- stocks are not publicized until the day after the trade is completed.

This difference between the NYSE and other markets underscores our commitment to a market system in which openness for all investors is critically important. By providing investors with instantaneous price and volume information on each listed security throughout the day, we enhance the attraction of the NYSE market system to investors.

Investors generally recognize that the NYSE markets in those securities attract the largest number of public participants, and can accommodate the greatest amount of activity while minimizing price variations from one trade to the next.

In terms of competitive prices, the NYSE market system faces considerable competition from across the country.

As a rule, the interaction among buyers and sellers on the NYSE trading floor and with the upstairs trading desks produces the best prices for NYSE-listed securities.

But if a better purchase or sale price for a particular stock is available in another market at a particular time, brokers access the better price for their firms' customers through the automated Intermarket Trading System linking competing U.S. equities marketplaces.

ITS is the electronic communications network linking eight equities markets nationwide that permits NYSE brokers representing public customers, specialists and other professionals to seek the best prices in other marketplaces around the country.

We consider ITS to be the linchpin of the National Market System. Other systems dealing with quotations and trade reporting are important informational components of the NMS. ITS, however, is the vehicle for trading among the competing markets for listed stocks.

Since ITS was inaugurated in 1978, the number of shares executed over the system has grown from 42,000 to 1.9 billion in 1988, the number of trades from 68,000 to 1.8 million, and the number of securities from 300 to 1,816. Of these stocks, 1,488 are listed on the NYSE.

Although its purpose is to serve as a balancing system, the number of shares traded through the ITS in 1988 were more than any U.S. stock exchange except the NYSE and the Midwest Stock Exchange.

INITIATIVES DESIGNED TO REINFORCE THE NYSE MARKET SYSTEM

All of the strengths of the NYSE market system that I have been discussing have enabled the NYSE to adjust to the rapid changes that have confronted the securities industry in recent years.

This was especially true during the past 19 months, when we redoubled our efforts to reinforce the marketplace and our regulatory capability. During this we instituted nearly 30 initiatives -- separately and with other markets -- which have bolstered the NYSE market system.

These include steps that have enhanced intermarket cooperation, technology, regulation, and interaction with our varied constituents. The actions are consistent with the recommendations in the various government studies on the market break, including those by the Presidential Task Force on Market Mechanisms, known as the Brady Commission, and the Securities and Exchange Commission.

One of the most important steps we took was to launch a new program aimed at insuring small investors are not crowded out during market dislocations. To do this, we have set up a special express service to facilitate their orders. We call it the Individual Investor Express Delivery Service.

This service enhances the position of individual investors by giving transmission priority to small orders during unusually active markets. It provides accelerated routing through SuperDot, our electronic order-routing and reporting system, to individual investor market orders of less than 2100 shares whenever the Dow moves up or down 25 points from the previous day's close. Once triggered, the service stays in effect for the remainder of the day.

Intermarket Cooperation

The NYSE started to develop ideas in the vital area of intermarket cooperation early in 1988 with the assistance of a committee of executives from leading securities and futures firms.

The primary result was a series of historic initiatives jointly worked out with the Chicago Mercantile Exchange, and all the equities, options and futures markets.

One was a "shock absorber" agreement between the NYSE and the CME which provides that if the price on the Standard and Poor's 500 futures contract traded on the CME declines 12 points, the futures contract price would not be permitted to fall further on the CME for 30 minutes.

Action would be taken simultaneously at the NYSE, where the 12 point drop in the futures contract price would be roughly equal to a 96 point decline on the Dow.

Orders identified in our automated order delivery system as involving program trading in the NYSE-listed components of the S&P 500 will be diverted into a separate computer file for five minutes.

At the end of the five-minute period, the orders will be eligible for execution. In the event of an imbalance in the supply and demand for a stock that could not be handled in an orderly fashion, trading in that stock will be halted until the imbalance is resolved.

The other landmark NYSE-CME initiative involved all the major domestic exchanges and markets. This was the coordinated circuit-breaker concept, under which trading in equities and their derivative products are suspended for limited periods of time in cases of excessive market volatility.

The plan became effective last October as a one-year pilot program. It provides that if the Dow Jones Industrial Average falls 250 points from the previous day's close, automatic trading halts will be triggered on all U.S. equities, options and futures markets for one hour. If, after trading is resumed, the Dow declines another 150 points in the same day, trading will stop for an additional two hours.

So far, neither the circuit-breaker nor the shock-absorber plan has been activated, because the threshold points have not yet been reached. But we believe that temporary trading interruptions of pre-designated lengths will provide vital cooling-off periods in times of extreme volatility. These interruptions will allow people to assess what is happening, and give investors greater opportunity to participate in the marketplace following such interruptions.

The NYSE and the CME also have jointly addressed the issue of frontrunning between futures and equities markets.

Historically, each market has had its own definition of frontrunning. Securities exchanges have considered frontrunning to mean trading in options on a stock or in the stock itself, with material, non-public information of an imminent transaction in the stock, whether or not a customer's order is involved. Futures exchanges have previously recognized frontrunning concepts to the extent that they involve members trading ahead of customers.

The NYSE and the CME have agreed on a third, common definition of what constitutes frontrunning between their two markets, and to prohibit such trading. Essentially, this interpretation defines intermarket frontrunning as executing a transaction in one market based on material, non-public knowledge of an imminent transaction in the other market which will have an immediate and favorable impact on the executed transaction. The NYSE has filed a proposed rule with the SEC aimed at preventing such abuses across equities and futures markets.*

In addition, the NYSE has offered to provide the futures market with audit-trail information on stock trading to assist in surveillance for frontrunning. I will have more to say about the upgrading of our audit-trail program internally later, in the initiatives section of my testimony.

Also in the interest of enhancing intermarket communication, we have taken a number of joint actions with other exchanges to increase the flow of shared information and to improve market surveillance.

In January 1988, the heads of several self-regulatory organizations met at the NYSE to discuss a variety of methods to improve communication among the equities, futures and options markets, and the NYSE has been meeting with regulators, other markets and industry groups in an ongoing effort to improve intermarket communication and cooperation.

A breakthrough achieved as a result of such meetings has been the recent establishment by the NYSE of an intermarket hotline to share information on an ongoing basis and to coordinate action during crises with all stock, options and futures exchanges and the National Association of Securities Dealers.

An earlier development involved a cooperative plan between ourselves and the CME that has eased volatility on expirations of the Standard & Poor's 500 futures contract. Under this plan, the expiration of the index futures contract has been moved from the close to the opening of trading on expiration Fridays, sometimes referred to as the Triple Witching Hour.

*--The rule was subsequently approved by the SEC.

Unfortunately the American Stock Exchange and the Chicago Board Options Exchange, which have the two largest options operations, are not participants in the agreement. This means that index options and individual stock options both expire at the close of trading on expiration Fridays. On March 17th, 1989, the most recent triple witching day when three contracts expired, 41 of 52 stocks had sell imbalances at 9 AM, and 29 of 52 had buy imbalances at 3:30 PM the same day. And on April 21st, 1989, when two contracts expired, 36 of 52 stocks had buy imbalances at 3:30 in the afternoon.

Expiring all contracts simultaneously at the opening would have a positive impact on the market in two ways. First, any imbalances in the market would have an entire trading day to be worked off. And second, coincident expirations may create offsets in the two products. We believe the degree of imbalances such as those on March 17th and April 21st could be mitigated if there were consistency throughout the industry as to the time of these contract expirations.

We are working with the Intermarket Financial Surveillance Group, which consists of representatives from commodities and securities exchanges, to establish cross-market sharing of financial and operational information. We also are working with the Monitoring Coordinating Group, whose members are from securities markets and clearing and depository entities, to coordinate use of financial, operational, deposit, clearing and settlement data.

In 1981, the Intermarket Surveillance Group was formed, consisting of representatives from the equities and options markets, to work jointly on surveillance matters between markets. More recently, the commodities markets dealing in index futures have been attending ISG meetings.

Technological Advancements

A second major group of initiatives undertaken by the NYSE over the past 19 months involves the enhancement of technology, which provides basic support for the NYSE market system and is an area we have been very active in over the years.

In just the last five years, the NYSE has spent more than $200 million improving the technology in our marketplace. And as one of our major initiatives over the past 19 months, we have committed an additional, significant amount toward systems improvements for the next five years. In fact, during this 19-month period, we have averaged at least one major systems improvement per month. These upgrades cover everything from the NYSE Consolidated Tape to behind-the-scenes processing systems.

SuperDot, itself, has undergone a major enhancement. It now enables member firms to send orders directly from brokerage offices around the United States to trading posts on our trading floor and have reported confirmations returned to the branch office much more efficiently.

To make SuperDot even more efficient, we've expanded the capacity of our limit order system -- which routes orders to the specialist for execution at a prescribed price -- by 50 percent since October 1987.

In addition, we've integrated into SuperDot our odd-lot order system, which handles orders in amounts of stock less than the established 100-share unit, providing substantially more capacity and faster response for odd-lot orders.

The ability of other markets to reach the NYSE through the Intermarket Trading System, or ITS, also has been significantly upgraded by the diversion of other message traffic from printers to the display books. The ITS network will be further enhanced soon, when incoming ITS commitments to trade will bypass printers and go to the display books.

As an additional means of assuring that ITS in the future is positioned to operate optimally in very active markets, the NYSE will be conducting a nationwide test of the system later this year. The test will encompass all the markets participating in the system, and will be geared to insure that the system and each market have the capability to process ITS traffic under growing and changing demands.

Among the many technological advances enhancing operations on the NYSE trading floor is the more-than-doubling of the number of electronic display books used by specialists to facilitate the recording, execution and reporting of orders. As a result, more than three times as many stocks are now displayed -- over 1,750 compared with 476 in October 1987.

There have been many more technological advancements instituted throughout the NYSE system, and we continually strive to be on the leading edge. That's why, for example, if there were interest in off-hours trading, the NYSE would mobilize its technological resources and launch an off-hours trading pilot.

But as yet, there has been little interest among our market participants to extend our trading hours. We've surveyed our member firms and institutional investors, and a majority expressed little or no interest in off-hours trading. Should that interest change, we will respond.

In the area of capacity, the NYSE in January 1988 expanded the capacity of our trading floor by one-fourth, with the addition of a new 7,000 square foot area equipped with state-of-the-art technology.

Capacity has been uppermost in our minds these past 19 months -- as it always has been.

NYSE policy historically includes contingency planning that calls for the continual buildup of our capacity to handle sudden spurts of trading volume far in excess of normal.

Such planning enabled us to handle on emergency basis the 600-million share days of October 19th and 20th in 1987 -- volume that was more than three times the norm.

We continue to aim at managing volume of 600 million shares a day as efficiently as we already process daily volume of 200 million shares. And it is our goal to be able to handle peak, one-day demand of one billion shares in the early 1990s.

Toward those ends, we have completed three of a planned series of Saturday systems tests since October 1987, the most recent one just five days ago.

The purpose of these tests is to simulate October 19th, address a variety of other factors and determine what needs to be done to build our capacity for the future.

The first test, in April 1988 -- simulating as best as possible the circumstances of October 1987 -- tested our internal systems. The second test, seven months later, included our member firms, and the last test included financial services vendors.

Currently, we have two additional tests planned. The next one, as I mentioned a little earlier, is scheduled for later this year involving the Intermarket Trading System. This test also will involve the Consolidated Tape and Consolidated Quotation. Next year we plan to run another test with our member firms, but at a higher capacity.

We have used outside consultants to help us develop our tests and to monitor them. Arthur D. Little has been an integral part of the process from the beginning, helping us plan and monitor the tests and conduct an independent assessment of our capability.

In addition, Peat Marwick has reviewed our model and simulations, monitored tests and conducted an independent review of our systems and processes. The firm completed its evaluation last September, and we plan to have it conduct additional studies approximately every 18 months.

The tests are run by a combination of NYSE staff and the Securities Industry Automation Corporation, or SIAC. The SEC, the GAO and the CFTC also are invited to witness the testing process.

We also are taking another major step in contingency planning in connection with SIAC. We are establishing a second SIAC facility that will split SIAC's data processing capabilities, so as to provide backup protection against a disaster that otherwise could seriously affect the trading or post-trading processes.

To help coordinate operational systems within our member-firm community, the NYSE in December 1987 established the Operations Advisory Committee. The committee is headed by Richard A. Grasso, NYSE president and chief operating officer, and is composed of senior operations officers from the NYSE's member firms. Its goal is to insure an integrated planning process between the NYSE and its member firms that will prepare our markets to serve customer demand in the years ahead.

Regulatory Enhancements

Earlier, I discussed the numerous meetings and actions the NYSE has taken in conjunction with regulators and other markets to improve regulation of the securities industry, as well as the steps we have taken to reinforce the position of our assigned dealers.

Now I would like to describe some of the other initiatives we have taken internally since October 1987 to strengthen our regulatory and market surveillance capabilities.

We have had to sharply expand our regulatory capability in the wake of the proliferation and increased complexity of products, innovative strategies, growth in volume, and the increased demand for SRO and member-firm regulatory activity.

In support of our accelerated regulatory efforts, the NYSE has substantially increased its financial commitment to regulation. We have budgeted $76 million for 1989, compared with $44 million in 1986.

Our expenditures include an ongoing automation-upgrade program geared to building a new generation of market surveillance tools based on leading-edge technologies, as well as a planned increase in regulatory staff from 373 in 1986 to 549 in 1989.

A major regulatory effort in 1988 was directed at sales practice abuses in the securities industry. This increased effort has enabled the NYSE to pursue many more cases in the past year, and to establish an enforcement unit dedicated to major sales practice investigations.

In another step forward, we have decided to take our comparison cycle from trading-day-plus-three to T-plus-One, or overnight comparison of all NYSE stock transactions. We hope to have this fully implemented by this time next year.

The new cycle means the period in which members and member firms are exposed to risk of loss due to market fluctuations on uncompared or questioned trades will be reduced considerably.

In my remarks earlier, I discussed the importance of audit-trails and the resulting high visibility of our trade information to investors and trading professionals alike.

The NYSE has been steadily improving its audit trail capability over the past decade, and since 1985 has had an ongoing program designed to maximize that capability. Our ability to capture data on the nine elements of audit trail has increased substantially since 1985. The percentage of data that we need and are collecting is now in the high 90s.

We will sharply improve the quality, or accuracy of our audit trail data, with the implementation of our Overnight Comparison System program. Phase One of that program, known as the Automated Correction Process, has the capability of enabling the NYSE and member firms to quickly correct inaccurate information and provide complete data for the audit trail.

Our goal is to achieve 100 percent capability, both in quantity and in quality. It is important, however, to keep in mind that the audit trail is not a panacea. The audit trail tracks transaction activity. It identifies the people involved in a trade, but it does not tell us their intent.

We continue to work closely on regulation with the SEC, the Congress, all other self-regulatory organizations and member firms to meet the growing need for more oversight and surveillance.

Recently, we completed a review of the full scope of our rules relating to trading processes on the trading floor. Following the review, we asked the SEC to approve numerous rule modifications and amendments which are designed to reinforce the exchange market system.

The final area of regulation I would like to talk about involves program trading, especially index arbitrage, in which investors use computers to hedge positions and profit on temporary disparities between prices of equities and stock futures.

In order to deal with volatile market conditions in early 1988, the NYSE experimented for several months early in 1988 with a trading "collar." This rule imposed an artificial restriction that prohibited member firms from using our automated order-routing systems to enter index arbitrage orders for any account for the remainder of the day if the Dow Jones Industrial Average moved up or down 75 points (lowered to 50 points in February 1988) from the previous day's close.

But in May of 1988, we started requiring members and member firms to submit daily reports on their program trading activity, including program trading on markets other than the NYSE. And three months later the NYSE began to publicly disseminate a monthly analysis of this data to the public.

We think this kind of disclosure is a better solution than some artificial restraint on the system such as the temporary collar, and in October 1988 we allowed the collar to expire. We believe that a system of openness and sunshine, in which we keep the public informed about levels and activities involving program trading, is more effective.

Currently, program trading accounts for about 10 percent of our overall volume. At this time, we don't see it having adverse effects on market stability or volatility.

Constituent Interaction

The last initiative I would like to talk about today are the steps taken to broaden the interaction between the NYSE and our various constituents.

One way the NYSE makes sure we are attuned to the needs of the people who participate in our marketplace is through our 13 advisory committees to the NYSE board of directors. Over the years, these committees have made substantial contributions to the success and growth of the NYSE market system.

Last year alone, we created four new advisory committees that reflect the most recent areas of change and growth. The new committees are on individual investors, pension managers, regulatory matters and Japan.

The Individual Investors Advisory Committee serves as a liaison between individual investors and the NYSE board and advises our board on policies and programs affecting individual investors in equities, options, futures and fixed-income securities.

The Pension Managers Advisory Committee consists of members representing corporate pension funds, state and local government employee retirement funds, endowments and foundations, and provides counsel on the concerns of pension managers.

The Regulatory Advisory Committee's members have a combination of industry, corporate and legal backgrounds, and advise our board on issues of regulation, self-regulation and the regulatory system as they affect the NYSE, the securities industry and the capital markets.

The Japan Advisory Committee counsels our board on the views and concerns of Japan's business and financial communities. It is chaired by a former foreign minister of Japan and comprises active or former senior officials of Japan's major public companies and financial institutions.

These new committees, along with the previously-created European and International Capital Markets committees, will help position the NYSE for the challenges of the 1990s -- and beyond.

All the initiatives undertaken by the NYSE over the last 19 months contribute to the strengthening of the NYSE market system.

PROPOSED LEGISLATION

Now I would like to turn to a brief discussion of the proposed Market Reform Act of 1989, which was proposed by the Securities and Exchange Commission on June 23, 1988 and was recently introduced as S. 648.

The legislation contains four sections: SEC emergency authority and trading halts, large trader reporting, risk assessment for holding company systems, and coordinated clearing and settlement.

I would like to comment specifically on each of these provisions.

SEC Emergency Authority and Trading Halts

The NYSE supports providing the SEC with authority to halt securities trading under the emergency circumstances spelled out in the legislation. Based on our experience during the week of October 19, 1987, we believe that giving this authority to the SEC is appropriate.

The NYSE hopes that the SEC will consult with us and other SROs before exercising this authority.

Large Trader Reporting

Concerning large trader reporting, the NYSE studied the matter to see if we could do it ourselves. We conducted two surveys on the subject with our member firms. As a result of our study and surveys, we concluded that any large trader reporting should be done through the SEC, and that it should be done across all markets.

Our surveys revealed serious concern about disclosure. We believe the best way to carry out large trader reporting probably is with a member firm file, which would be disclosed upon SRO or regulator request. We also think that the rules for calling up the file should be very narrowly defined, such as for the purpose of reconstructing the market after an October 19th or in connection with possible insider trading.

We should keep in mind, however, that enforcing such a requirement on an international basis may be difficult, because of the inconsistency in disclosure rules and audit-trail practices in U.S. markets and those overseas.

Risk Assessment for Holding Companies

When you get into risk assessment for holding companies, you are getting into an area of potential danger. There is concern about holding companies with broker-dealer affiliates because no one knows what is happening in the entire holding company.

The NYSE does not want to regulate holding companies, but it believes some agency such as the SEC should gather sufficient data to assess the financial soundness of holding companies that are parent companies of broker-dealers. As financial institutions enter non-traditional businesses not subject to SRO oversight, they have the potential to create systemic risks domestically and internationally.

Coordinated Clearing and Settlement

The NYSE agrees with the SEC that the clearance and settlement system for securities should be strengthened, and that clearance and settlement of securities and securities derivative products should be coordinated. But here again, a distinguished international private-sector financial body, The Group of Thirty, has pointed out the threats of national and international systemic risk involving even regulated entities.

We also think that, beyond the involvement of the SEC and the CFTC, it is important that there be coordination with the Treasury Department and the Federal Reserve Board, as far as clearing and settlement is concerned. And we agree with Treasury Undersecretary Robert Glauber that coordinated clearance and settlement should be the number one priority of the Presidential Working Group.

CONCLUSION

That concludes my comments on the NYSE market system, what we've done since October 1987 to strengthen the system, and the four sections of the proposed Market Reform Act of 1989.

Perhaps the theme that runs throughout my testimony today is, as it was once put, "eternal vigilance is the price of survival." This is true, not just for the NYSE market, but for all U.S. markets.

The NYSE not only has been vigilant in its pursuit of survival. It also has been a leading force in the capital-raising and asset-allocation process that has been the bulwark of the U.S. economy. All the comprehensive measures we have taken over the past year-and-a-half to strengthen the NYSE market system will help maintain our strong position and our contribution to the U.S. and world economy into the next century.

Thank you.

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Memorandum

ATTACHMENT 1

NYSE
New York
Stock Exchange, Inc

Date: March 3, 1989

To: All Members on the Floor

From: Market Performance Committee

Subject: New Specialist Job Description

The new Specialist Job Description is attached for your information. This document specifies key expectations with respect to performance of NYSE specialists. We believe the new job description effectively positions Exchange specialists to meet the evolving, competitive demands of the 1990s.

Given the profound changes in the Exchange marketplace since adoption of the original Specialist Job Description (June 1976), the Market Performance Committee initiated a comprehensive review of the job description. Our objective was to determine what revisions were appropriate to more accurately reflect the role of the specialist in today's markets. To this end, the MPC sought input from a diverse group of specialists which developed recommendations. Their input received extensive evaluation and review by the Market Performance and Allocation Committees, the advisory committees of the Board of Directors, the Specialist Critical Issues Organization, and floor broker and operations representatives of member firms. The resultant job description represents a solid, consensus document which was approved by the Quality of Markets Committee and, just recently, the Securities and Exchange Commission.

The new Job Description emphasizes the following responsibilities of specialists:

- Ensure the quality and competitiveness of Exchange markets, in all market segments;
- Stress service to member firms. Provide timely, accurate and complete information on market activity, on an equal and impartial basis, to all inquiring members;
- Ensure adequate, trained staff; efficient administrative procedures; efficient use of financial resources; and use of appropriate Exchange systems;

- Adhere to Exchange performance standards; and
- Attempt to meet annually with listed company executives, as well as appropriate on-floor and off-floor member firm representatives.

The old job description was supplemented by a Code of Acceptable Business Practices. The new document incorporates the code, thereby eliminating duplication and enhancing clarity. It also specifies specialists' responsibilities within the five functions on which the performance of specialist units is evaluated in the SPEQ, and identifies key competitive responsibilities. Among the eligibility requirements, the new job description provides that applicants to become specialists must participate in an orientation session with a panel of market professionals.

We recognize that our individual and aggregate performance is receiving increasing scrutiny by the public, the press, regulators, listed companies and our broker-dealer customers. Each specialist's performance significantly affects the efficiency, competitiveness and overall quality of Exchange markets, and largely determines the Exchange's success as the world's premier securities market. Clearly, it is the responsibility of each specialist to fulfill the performance expectations codified in the new Specialist Job Description. The job description will be the subject of careful, ongoing review and will be revised, as necessary, to ensure that the responsibilities it articulates continue to be consistent with the needs of the marketplace.

The members of the Markets Performance Committee stand ready to assist specialists in fulfilling these expectations.

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THE NEW YORK STOCK EXCHANGE, INC.

SPECIALIST JOB DESCRIPTION

I. OBJECTIVE

An Exchange member registered as a specialist is accountable to the Exchange for the quality of the Exchange markets in the securities in which the specialist is registered. The specialist is responsible for fostering and acting to maintain liquid and continuous two-sided agency auction markets by acting as agent and principal in those securities on the Exchange floor. The specialist helps ensure that such markets are fair, orderly, operationally efficient and competitive with all other markets in those securities. A "fair" market is free from manipulative and deceptive practices and affords no undue advantage to any participant. An "orderly" market is characterized by regular, reliable operation, with price continuity and depth, in which price movements are accompanied by appropriate volume, and unreasonable price variations between sales are avoided.

As is true of all Exchange members, the specialist is expected to adhere to all applicable Federal laws and regulations, and Exchange rules and policies, including the provisions that apply to specialists in Section 11(b) of the Securities Exchange Act of 1934, Rule 11b-1 thereunder, Exchange Rule 104 and ITS rules. In this way, the specialist actively contributes to maintaining high quality Exchange markets in the public interest. Because of the specialist's central position in the Exchange's continuous two-way agency auction market, the manner in which and the degree to which the specialist performs significantly affects the efficiency, competitiveness and overall quality of Exchange markets, and largely determines the Exchange's success as a national securities market. Therefore, specialists are expected to enhance their performance in the ways set forth in the Specialist Job Description.

The specialist occupies a position of public trust and should act at all times in a manner consistent with that trust. Therefore, it is essential that the specialist adhere to the highest standards of business and ethical conduct in the performance of all aspects of the specialist's job. This duty is formalized by the Exchange's Rule 401 which states that members must "at all times adhere to the principles of good business practice". Failure to do so can be detrimental to the Exchange and constitutes a breach of public trust.

The Specialist Job Description is intended to guide specialists in the performance of their duties. Certain specific areas are enumerated below, and may be modified by the Exchange as circumstances require. This is not to be construed as a complete list of specialist duties and, in circumstances not specifically addressed below, the specialist should be guided by the spirit and intent of the Job Description.

Acts or omissions by the specialist that appear to be inconsistent with the Specialist Job Description are addressed by the Market Performance Committee and via the regulatory process. Exchange Rule 103A provides standards with respect to performance of these duties. It is under that rule that the Market Performance Committee monitors the specialist's fulfillment of the expectations set forth in the Specialist Job Description, and takes steps to encourage performance improvement. Where circumstances warrant, the Exchange may take disciplinary action under Rule 476.

II. PRIMARY DUTIES

A. AGENCY FUNCTION

In view of the specialist's central position in the Exchange's continuous two-way agency auction market, a specialist should:

Act as agent on behalf of orders entrusted to the specialist, hold the interests of such orders above the specialist's own, and properly represent each order, regardless of its size or source, in the marketplace to ensure the timely and best possible execution in accordance with the terms of the order and the rules and policies of the Exchange.

B. DEALER FUNCTION

In performing as a principal a specialist should:

1. Affirmative Obligation

   Buy and sell securities as principal when such transactions are necessary to minimize an actual or reasonably anticipated short-term imbalance between supply and demand in the auction market and do not upset the natural longer term forces of supply and demand, and effect such transactions when their absence could result in an unreasonable lack of continuity and/or depth.

2. Continuous Market

   a. Make firm and continuous two-sided quotations that are timely and accurately reflect market conditions, and ensure that principal transactions are calculated to contribute to the maintenance of price continuity with reasonable depth, and that such transactions are effected relative to the general market, the market in the particular security and the adequacy of the specialist's total position in the security with respect to the actual or reasonably anticipated needs of the market.

b. Ensure that the election of a Stop Order results from the fair and orderly price movement of the stock and not from poor performance or inadequate depth.

3. Negative Obligation

a. Provide an opportunity for public orders to be executed against each other without undue dealer intervention within the context of the current market, and not deal in a manner that is inconsistent with the overall objective of maintaining a fair and orderly market, as defined above.

b. Given a reasonable time frame and lack of substantive change in market conditions, refrain from interfering with a cross when the specialist has previously indicated "no interest".

c. Refrain from interfering with a "clean" agency cross unless the specialist's bid or offer has been previously solicited; or unless the reasonably anticipated needs of the market require the specialist to do so in order to be able to fulfill the market maintenance responsibility of the specialist and a floor official has been consulted in the event of any disagreement.

4. Financial Resources

Effect principal transactions in a manner that is consistent with the specialist's financial resources and that maximizes the efficient use of those resources, and report promptly to the Exchange any actual or imminent financial problems that may affect the specialist's ability to fulfill the responsibilities of the specialist to the market.

C. MAINTAINING THE AUCTION MARKET

In opening and reopening trading in a listed security, a specialist should:

1. Market Openings and Reopenings

a. Initiate trading in each security as soon as market conditions allow, at a price that reflects a thorough, professional assessment of market conditions at the time and appropriate consideration of the balance of supply and demand as reflected by orders represented in the auction market, taking extra care, however, when the opening or reopening price is significantly different from the preceding closing price, and maintain continuous fair and orderly trading in the aftermarket.

b. Seek the advice of floor officials in a timely manner in requesting delays in openings or trading halts when warranted by unusual market conditions.

2. Market Coordinator

Serve as the market coordinator for the securities in which the specialist is registered by exercising leadership and managing trading crowd activity, and promptly identifying unusual market conditions that may affect orderly trading in those securities, seeking the advice and assistance of floor officials when appropriate.

3. Market Catalyst

Acts as a catalyst in the markets for the securities in which the specialist is registered, making all reasonable efforts to bring buyers and sellers together to facilitate the public pricing of orders, without acting as principal unless reasonably necessary.

D. COMMUNICATION FUNCTION

In view of the specialist's central position in the Exchange's continuous two-way agency auction market, a specialist should:

1. Equally and impartially provide accurate and timely market information to all inquiring members in a professional and courteous manner.

2. Indicate the depth of the current market, to the extent the specialist's agency responsibility allows, in response to any reasonable inquiry from a member.

3. Equally and impartially provide all inquiring members with accurate, complete and current opening price indications and pre-opening information, such as the amount of stock paired off and the excess to buy or sell.

E. ADMINISTRATIVE FUNCTION

A specialist's administrative and operating practices can have a significant impact on the quality and competitiveness of the market. Therefore, a specialist should:

1. Employ efficient administrative procedures that enable the specialist to maintain accurate and up-to-date records, process trade documents efficiently and accurately, and respond promptly to requests for order or market information.

2. Promptly provide information when necessary to research the status of an order or a questioned trade, and cooperate with other members in resolving and adjusting errors.

3. Accurately report executions of orders entrusted to the specialist in a timely and complete manner and provide information, when requested, on the status of orders and the confirmation of open orders.

4. Maintain a level of trained staff on the Exchange floor at all times sufficient to meet periods of reasonable demand, and provide the supervision necessary to ensure the efficiency and professionalism of the specialist's operation.

5. Ensure that, during an absence from the post, the replacement on the floor is aware of all pertinent information related to the securities in which the specialist specializes.

6. Make arrangements for supplementary staff and financial resources that may be necessary to meet extraordinary market conditions.

7. Utilize Exchange systems and procedures.

F. COMPETITIVE RESPONSIBILITIES

Recognizing the intensely competitive environment in which the specialist operates, the specialist should:

1. Make every effort to be fully competitive in all segments of the market and to maintain and increase market share in the securities in which the specialist acts as the specialist.

2. Establish a positive professional relationship with Exchange listed companies and each year extend an invitation to meet

with representatives of the listed companies in which the specialist specializes to acquaint them with the workings and operational aspects of the agency auction market system.

3. Each year extend an invitation to meet with appropriate on- and off-floor representatives of those member firms with which the specialist conducts a significant business and such other member firms as are deemed appropriate to discuss the service, operational and competitive requirements of the member firms.

G. OTHER MARKET RESPONSIBILITIES

In addition to these duties, the specialist is expected to:

1. Assist the Exchange in developing and implementing systems and procedures designed to enhance the efficiency and competitiveness of the Exchange's agency auction market, and to satisfy Federal requirements.

2. Comply with all measures and standards of performance established by the Exchange, understanding that failure to meet these standards could subject the specialist to prescribed performance improvement procedures, which may include the reallocation of a security or securities.

3. Keep records required by Federal and Exchange rules, promptly and accurately report required information to the Exchange and comply with all Exchange rules which govern the financing of specialist operations.

4. In addition to the above, take any actions not prohibited by Federal or Exchange rule or policy or precluded by professional judgment to foster and maintain liquid continuous two-sided agency auction markets on the Exchange floor and to ensure that such markets are fair, orderly and efficient in the public interest and competitive with non-Exchange markets in Exchange listed securities; and avoid any action which would hinder the achievement of these objectives.

III. ELIGIBILITY REQUIREMENTS

An Exchange member who desires to be registered as an Exchange specialist must:

1. Be associated with an existing or newly created specialist unit approved by the Exchange.
2. Complete an adequate training period under the supervision of an experienced specialist.
3. Pass the Exchange-adminstered specialist examination.
4. Ensure that the specialist unit with which the specialist is to be associated meets the Exchange's specialist capital requirements.
5. Participate in an orientation session with a panel of market professionals, whose membership will be drawn from the Market Performance Committee, to discuss the responsibilities and duties of being an Exchange specialist.

September 3, 1987

Senator Dodd. Thank you very much, John.

Mr. Hardiman, welcome.

STATEMENT OF JOSEPH HARDIMAN, PRESIDENT, NATIONAL ASSOCIATION OF SECURITIES DEALERS

Mr. **Hardiman**. Thank you, Senator.

I would like to express my appreciation for the opportunity to appear before you today.

The NASDAQ market is a little different from the New York Stock Exchange. Participation by individual investors in our market is more prevalent. Individual investors own two-thirds of the market value of NASDAQ stocks and represent approximately 60 percent of the trading volume that takes place in our market. The absence or the presence of the individual investor is a very meaningful aspect of our marketplace, and I will comment upon that in greater detail in a few minutes.

I do recall that Senator Riegle and I met last year, and he asked us if we could undertake a survey of individual investor attitudes. We did. If you would like, I would be happy to submit a copy of that survey for the record.

Senator **Dodd**. We will make that part of the record.

Mr. **Hardiman**. I will first briefly comment upon the NASD changes in response to the market break, then comment on the specific piece of legislation and finally talk a bit about current issues and the future direction of the equity markets.

The NASD has taken a number of actions to assure access to investors both large and small in the NASDAQ market, with an emphasis on the small investor. The reason is that access was the most crucial problem in our marketplace during that tumultuous period of October 19th and 20th.

The changes have focused on our Small Order Execution System. That is an automated execution system designed primarily for individual investors to execute automatically up to 1,000 shares of securities that trade in our national market system, at the best available prices in the market.

What we have done is to make participation in that Small Order Execution System mandatory for all market-makers. Prior to October, it was voluntary. We have revised the system to make sure that it operates in fast-moving markets, notwithstanding what are known as locked or crossed markets. That was a problem during October 1987.

We have also put restrictions on members who wish to withdraw as market-makers from re-engaging in that activity for a period of 20 business days. Lastly, we have set minimum market-maker commitments for each quote that appears, for 1,000 of our largest and most active stocks. That minimum quote has to be for 1,000 shares for most of these stocks.

Since 70 percent of the volume of NASDAQ public trades are eligible for SOES or related proprietary systems that member firms own and operate themselves, all of which provide for automatic execution, we believe that the steps we have taken have eliminated a major NASDAQ bottleneck which we experienced during October of 1987.

In addition, we have implemented a number of other systems changes which will allow our market-makers to communicate with each other directly by computer, rather than having to access each other by telephone, which was the focal point of our bottleneck.

Lastly, just last week the NASD board approved a new automated confirmation system, which will provide on-line, real-time comparison of transactions that take place in our marketplace.

What that in essence does is to compare both sides of the transaction in a very concise period of time. That will assure that some 95 percent of the transactions that take place in the NASDAQ market will be automatically compared and locked in for settlement purposes on the trade date, which is 1 day in advance of that recommended by the Group of 30.

These changes were recognized by the Brady task force which, in its study, concluded that had these proposed rules been in effect during the market break, it is possible, if not probable, that most of the problems encountered in executions in our market would not have occurred.

As far as Senate 648 is concerned, we believe that the markets, as John has pointed out, have worked well together to address many of the issues that we saw, and that the level of coordination and cooperation among markets, certainly in my brief tenure in this job, is at an all-time high.

But we do have problems with several of the provisions of Senate 648. We support strongly the provisions dealing with coordinating the clearance and settlement of the securities and futures markets, and believe that the study that John suggested would be appropriate, whether it is conducted by the Working Group or by the special study that was authorized by the Insider Trading Act last year.

We have questions on those provisions on large trader reporting and holding company risk assessment. We oppose, as we have consistently, provisions relating to trading halts. We think that trading halts, in and of themselves, relieve markets of their primary responsibility, and that is to remain open and operating during all market conditions. I believe, strongly, that one of the most salutary things that came out of the October 19th and 20th market breaks was the fact that the markets did remain open, operating continuously, albeit not perfectly, throughout, providing investors with liquidity and price discovery, which is the function of securities markets.

As far as future market problems are concerned, the issues of clearance and settlement and the varying margin requirements amongst the markets are the areas to focus upon. Performance and maintenance margins should be set at levels to equate to the leverage that is related to the risk of the securities and to market participants. We think there is some further work to be done in this area, and perhaps the need for a coordinating hand at the federal level.

In connection with one matter that is unrelated to the equity markets, but that I did want to comment upon briefly today, the NASD has observed a growing problem with abusive sales practices involving U.S. Government securities. At the present time, the NASD and the SEC lack the authority to deal with such problems unless it can be demonstrated that they constitute fraud. We have initiated correspondence with the Treasury Department, to see if we can introduce amendments to the 1986 Government Securities Act that would extend our regulatory authority to include such practices within our disciplinary process.

Last, commenting upon the Group of 30 report, we embrace its goals which are essentially to compress the clearance settlement and payment time frame, to promote efficiency, and importantly to reduce risk for all participants. In examining their recommendations it is basic that the impact upon the individual investor, who continues to be a key participant not only in our market but also to the success of all equity markets in the United States, is taken into account. Some of those provisions could have a significant impact upon the ability of the individual investor to participate in the securities markets.

Thank you very much.

[The complete statement of Mr. Joseph Hardiman follows:]

TESTIMONY OF

JOSEPH R. HARDIMAN
PRESIDENT
NATIONAL ASSOCIATION OF SECURITIES DEALERS, INC.

BEFORE THE
SUBCOMMITTEE ON SECURITIES
OF THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

MAY 18, 1989

My name is Joseph R. Hardiman and I am President of the National Association of Securities Dealers, Inc. (NASD). The NASD is registered with the Securities and Exchange Commission (SEC) as a national securities association under the Securities Exchange Act of 1934. The NASD is the only association so registered. It is charged with the responsibility of regulating both the National Association of Securities Dealers Automated Quotation System (NASDAQ), which is the second largest securities market in the United States and the third largest in the world, and the over-the-counter securities markets. This task encompasses both regulation of NASD member broker dealer firms and the regulation and operation of the NASDAQ system.

The NASD employs about 1,700 people, and has over 6,400 broker dealer members employing 450,000 registered sales persons and principals. Some 5,080 securities issued by 4,400 companies are quoted in the NASDAQ system and 570 NASD members serve as market makers in those securities.

NASDAQ is a completely open electronic market with intense competition between market makers. Their bid and offer quotations are continuously displayed over thousands of subscriber terminals, with real time transaction reports for all NASDAQ National Market System stocks. Ownership and participation by investors in the NASDAQ market is broad and diverse. Individual investors hold approximately two-thirds of the market value of NASDAQ stocks. Institutional investors are also very active in NASDAQ, but individual participation is paramount.

The NASD carries out its examination, disciplinary, and other regulatory responsibilities through its Washington headquarters and 14 District Offices located in major cities throughout the country. In additional to disciplinary committees that work with each District Office, the NASD has a national Market Surveillance Committee that deals specifically with market and trading related issues. A committee of the NASD Board of Governors, the National Business Conduct Committee, reviews as an appellate body the disciplinary activities of the District Business Conduct Committees and the Market Surveillance Committee, and seeks, to the extent possible, uniformity in disciplinary actions. Final disciplinary actions can be appealed to the SEC and then to the United States Courts of Appeals.

In its request for testimony, the Committee asked the NASD to address whether, in view of the regulatory, self-regulatory, and private sector reforms and initiatives taken in the wake of the October 1987 market break, there is a need for legislation in this area. The Committee also posed the broader questions regarding what Congress, the regulatory agencies and the self-regulatory organizations should be doing to prepare for the challenges facing our markets in the next decade.

By way of summary, the NASD supports the provisions of S. 648 for coordinating clearance and settlement among the equity and derivative markets, but questions the need -- unless a greater demonstration of need can be made -- for those provisions on large trader reporting and holding company risk assessment, and opposes the provisions relating to trading halts. We think that the issues remaining from the market break of 1987 are now being effectively addressed by the joint efforts of the regulators, the self-regulators, and the industry, and that legislative solutions will unnecessarily limit the flexibility necessary to respond to market conditions as they develop. Indeed, this flexibility permitted the markets to continue, open and operating, during the market break, preventing an even greater uncertainty and loss of investor confidence. We see the greatest challenges to the U.S. securities markets to stem from responding to pressures of automation and international competition while maintaining the high standards of investor protection we all endorse for our markets.

NASD Changes in Response to the Market Break

The NASD has taken numerous actions since the market break to assure access to investors both large and small to the NASDAQ market during all market conditions. Included at Appendix A is a chronology of those actions. My testimony will concentrate on the more significant changes that we have made to respond to the events of October 1987.

Notwithstanding the extraordinary volume and price volatility during the market break of 1987, the NASDAQ market remained open and functioned continuously in every stock. The major problems we faced were not with the capacity or operation of the computerized systems on which our market is founded, but with the telephone congestion and the human component, as the telephone mode of execution was overwhelmed with the flow of orders. Thus, access to the markets became the most crucial problem for both institutional and individual investors.

In the NASDAQ market, the surge of selling coupled with rapidly changing prices hindered the ability of overburdened market makers to update their quotations. Because our Small Order Execution System (SOES) and other related proprietary systems were pre-programed to shut down when pricing anomalies occurred, the execution of those trades was diverted to other means, thus increasing telephone congestion. The NASD has responded to this and the other problems it has discovered during the October 1987 market break in the following manner:

Contingency Plans The NASD Board of Governors has adopted amendments to its By-Laws to enable its President and Board Chairman to expeditiously take emergency action, if required, during periods of highly volatile market conditions.

SOES SOES, and related proprietary systems, provide automatic execution of customer orders up to 1,000 shares at the "inside" or best price, without the need for telephone contact and negotiation by dealers. Originally built into such systems was a fail-safe mechanism to protect against inadvertent pricing errors. This feature, as the market break demonstrated, reduced the value of SOES and the other related proprietary systems during fast moving markets, affecting the smaller investors whose trades are ordinarily automatically executed at the best bid and offer in NASDAQ.

The following changes to SOES have now been implemented in response to the market break:

- Participation in SOES is now mandatory for all market makers in NASDAQ/NMS securities, assuring the small investor access to market makers.
- SOES orders in NASDAQ/NMS securities will be executed automatically notwithstanding a locked or crossed inside quotation market, thereby assuring the continued execution of NASDAQ/NMS trades even during extremely frenetic markets.
- Market makers who withdraw from trading a security may not again make a market in that security for 20 business days.
- Minimum market maker commitments for each bid displayed have been tiered to relate to the trading activity in those securities. These tiers are 1,000 shares for nearly 2,000 of the most actively traded National Market System securities, 500 shares for some 600 less active issues, and 200 shares for the least active NASDAQ/NMS securities, which number approximately 400.
- A limit order file has been created for the benefit of small investors, so that they may place orders away from the inside price, which will be executed when the inside market reaches the limit price.

Since 70% of NASDAQ public trades are eligible for SOES or related proprietary systems that provide automatic execution, we believe a major NASDAQ bottleneck experienced during the market break has been eliminated.

OCT Another major NASDAQ response to the market break is the implementation of the Order Confirmation Service (OCT) in early 1988. This allows market makers to direct orders of any size to another market maker by computer - thus bypassing the telephone system. The order is displayed on the computer screen of the recipient and, if accepted, is automatically executed, reported worldwide, and sent to the clearing corporation as a compared trade, locking in all the necessary post execution steps.

TARS The NASD maintains a Trade Acceptance and Reconciliation Service (TARS) for its members. This allows participants to reconcile their uncompared over-the counter transactions on-line, computer to computer. Since its beginning in 1982, this system has accounted for a significant reduction in the uncompared rate of transaction in the market and is now used to resolve 85% of all uncompared over-the-counter transactions processed by registered clearing agencies. During the market break the NASD expanded the operating hours of TARS, which quickly brought the uncompared rate back to normal levels. The NASD has taken further steps to ensure utilization of TARS by all NASD members who participate in a registered clearing agency. At its recent meeting, the NASD board voted to make TARS participation mandatory for all firms that are members of a clearing corporation and to expand the system to permit reconciliation of differences through the computer.

ACT As a further enhancement to the critical clearance and settlement process, the NASD announced last month that an on line trade confirmation service, Automated Confirmation Transaction (ACT) will begin in mid summer. This system automates trade comparisons, the first and most important step in the clearance and settlement process. It will require that all trades be input, other than trades locked in through automatic execution systems such as SOES and OCT, to NASDAQ electronically for matching within 6.5 minutes after the trade. As a result, we anticipate that at least 90 percent of all NASDAQ trades will be compared within minutes after they occur, 95 percent will be compared by the end of the trade day, and the balance compared by the following day. Establishing ACT is the most significant action taken by any market to shorten and enhance the clearance and settlement process. The service will improve the risk management abilities of market participants by reducing market exposure to price movements, producing faster, more efficient trade confirmations, and decreasing the risk and expense of clearing NASDAQ transactions.

The numerous changes taken by the NASD in response to the market break have resulted in a NASDAQ market more fully prepared to react to extraordinary market conditions for the benefit of investors. Indeed, the Brady Task Force concluded that "had the proposed rules [discussing only SOES and OCT] been in effect during the market break, it is possible, if not probable, that most of the problems encountered in the execution of small orders in the over-the-counter market would not have occurred".

S. 648 - Market Reform Act of 1989

S. 648, the Market Reform Act of 1989, was introduced at the request of the Securities and Exchange Commission in the Senate on March 17, 1989. A companion bill is HR 1609, introduced on March 23, 1989. The NASD has reviewed S. 648 in response to the Committee's request and has a number of comments to make on its four major sections: SEC Emergency Authority and Trading Halts, Large Trader Reporting, Risk Assessment for Holding Company Systems, and Coordinated Clearance and Settlements.

SEC Emergency Authority and Trading Halts - These provisions of the bill would permit the SEC to take emergency action on any area covered by the Securities Exchange Act of 1934 (the "Exchange Act") that is regulated by the SEC or the self regulatory organizations, including altering, supplementing, suspending, or imposing requirements or restrictions on trading in any and all securities (other than exempted securities) on any national securities exchange or otherwise. Any action the SEC would take is limited to ten days, except summary trading halts are limited to 24 hours, extendable for not more than two additional 24 hour periods if the President approves. Emergency is defined to mean major market disturbances that threaten fair and orderly markets or the national clearing system. Emergency action taken by the SEC could be reviewed by the courts, but in a narrowly defined manner.

As a general principle, we think that markets should strive to remain open under all market conditions, to provide the liquidity and price discovery on which individual and institutional investors rely. The fact that the markets remained open and functioning, although not perfectly, during the market break of October 1987 probably averted a much more serious financial crisis. If the equity markets do not provide that liquidity because of trading halts, the resultant uncertainty may prompt investors to seek liquidity in the debt markets, from banks, or wherever they can find it, with possible severe consequences for those sectors. Moreover, volatility -- which trading halts seek to contain -- is likely to increase before and after trading halts, "circuit breakers", or other artificial constraints are placed on market activity.

With this in mind, the NASD Board of Directors on September 20, 1988 issued a policy statement that it did not believe market closings were the answer to sudden and steep declines in market prices. It recommended instead that Congress should vest authority over all equity derivative instruments in the SEC and give the SEC oversight of prudential or maintenance margin requirements by self regulatory organizations for all equity instruments; that clearing and settlement systems should be coordinated; that an intermarket self-regulatory coordinating policy group should be established; and that any legislation needed to accomplish these recommendations should be enacted promptly. Acknowledging the risk of being the only equity market open when others had closed because of large price movements, the Board reluctantly agreed -- for an interim period of one year -- that it would halt trading on NASDAQ at the request of the SEC.

We urge caution on market closings because of the adverse effects on investor confidence. When the Hong Kong market closed during the October 1987 market break, confidence in the system eroded, and it took a week for the market to be reopened, and at least a year for confidence to be restored.

We do, however, continue to support trading halts in individual securities for a short period (e.g., for a half an hour) for the dissemination of material news to all investors. In July 1988, the SEC approved our request to upgrade our ability from halting quotations for NASDAQ securities, to halting trading. In August 1988 the SEC approved our requested rule change requiring notification by issuers of the NASD before material news announcements, to strengthen the effect of any resultant trading halts.

Large Trader Reporting - These provisions are patterned after the Commodities Futures Trading Commission's (CFTC) authority, and are designed to assist the SEC's surveillance of markets. They empower the SEC to adopt rules to require large traders to file reports on their trades with the SEC or the self regulatory organizations. The provisions cover large trades in "publicly traded securities", which includes exchange listed and NASDAQ quoted securities.

While the NASD would welcome additional surveillance information, we do not see that this proposal has been justified as a needed response to a clear problem. Given the high costs of compliance, we do not see that the benefit from this reporting would compare favorably with the costs, especially since the information required can be readily obtained from the members, and the reporting may be overly burdensome to the industry and may be drafted too broadly to obtain what the SEC needs to improve its regulatory capability.

The information that the proposal seeks is available to the SEC under current practice through direct inquiry by either automated systems of the NASD or the exchanges. The equity audit trail available in NASDAQ records the details of every trade reported in NASDAQ/NMS securities. These trade reports are then matched against clearing data for the contra side of the transaction. Once ACT goes on line in mid summer these data for both sides of the trade will available even more quickly and accurately. Furthermore, the NASD's Retail Account Name Search (RANS) provides market surveillance with a history of trading in suspicious accounts. The electronic blue sheets designed by the Intermarket Surveillance Group and used by the SEC allow investigators to collect detailed account information, including public customer names, for trading in any stock they target within days. These blue sheets provide the same information that is now sought by this proposal, although they are used only when problem activity has been identified.

The information sought in this proposal may be burdensome to the industry because it will be required in all large trades even though the SEC and the self regulatory organizations may only be interested in a very small fraction of those trades.

Finally, we are concerned that the language as drafted is too broad, and is unclear as to the tiers of ownership that may be required to be reported. In a time of rapidly expanding international trading of U.S. securities, we are concerned that this provisions' potential impact on forcing more securities offshore must be carefully considered.

Risk Assessment for Holding Company Securities - These provisions seek to clarify the SEC's authority to require reports on the activities of associated persons of broker-dealers and government and municipal securities brokers and dealers which could materially affect the financial or operating condition of the broker-dealer. No reports would be required of individuals, or for banks, savings and loans, insurance companies, futures commission merchants, or introducing brokers if they were otherwise regulated. The provisions would also empower the SEC to require additional reports of NASD members if they are influenced by their associated persons.

The NASD is well aware of the need to monitor the soundness of broker dealers, and devotes a good deal of its regulatory resources to accomplish this important responsibility.

We are not aware, however, of any need for this information. Moreover, we are unclear on the reasoning behind the various exemptions from coverage. These exemptions, could, given the variety of those with significant interests in broker dealers, unjustifiably discriminate to exempt a broker dealer from coverage merely because it was owned by an insurance company, or was affiliated with a savings and loan association, even though that affiliation could result in risk to the broker dealer. If these exemptions are based on the availability of information for these entities, it would appear that the exemptions should also extend to Section 12 reporting companies. Finally, we are concerned about the potential impact this provision may have on affiliates of international institutions that have domestic broker-dealer affiliates.

Coordinated Clearing - These provisions would require the SEC to work with the CFTC and the Federal Reserve Board (FRB) to facilitate the establishment of linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options on them, and commodity options. The SEC would be authorized to preempt state laws, such as the Uniform Commercial Code, if they impede the national clearance system.

The NASD strongly endorses coordinated clearing. In its September 20, 1988 statement on circuit breakers, the NASD Board specifically recommended as a more pressing need than trading halts that:

> The activities of clearing and settlement systems should be coordinated across market places to reduce financial risk for all participants. Clearing and settlement facilities for all equity derivative instruments should be unified or linked as in the options and securities markets.

While a centralized clearing system may be an ideal, we do not believe it to be a practical solution in the foreseeable future. The markets for equities, options, and futures each function differently and transactions are settled using different time frames and different market structures.

We believe that clearing entities for all markets should share meaningful information on the credit exposure, operating condition and potential surveillance problems of firms trading in the various markets. Without timely, complete information on a firm's exposure in all markets, no one clearing entity can assess that firm's credit worthiness on an ongoing basis. A similar need for information may be faced by banks that extend credit to firms. If those banks had access, with each firm's prior agreement, to information on firms' exposure in all markets, the banks should be in a better position to respond to the needs of market participants.

S. 648 Summary While the NASD supports the goals sought by the SEC in submitting S. 648, we think that many of those changes that are positive are also unnecessary. Regulators, the self regulatory organizations, and the markets are now engaging in a variety of activities to improve clearance and settlement and market surveillance, which appear to us to be the main positive effects of S. 648. The thrust of the bill is to accomplish through legislation that which is are now being carried out by cooperation. Unless a case can be made that the pace of reform is too slow, or otherwise needs the relatively less flexible approach of legislation, we question the need for S. 648 in its current form.

Future Market Problems

We have striven to respond to and solve those problems that we identified with the NASDAQ market during the market break, and are confident that our many changes -- especially those improvements to SOES and the creation of OCT and ACT -- will prevent a reoccurrence of problems. We think that one remaining issue yet to be addressed adequately is varying margin requirements among the equities and derivative markets.

The Brady Report recommended that margins should be made consistent across marketplaces to control speculation and financial leverage, and the NASD supports the view that performance or maintenance margins on various types of securities should be set on a consistent basis in all markets. This does not mean that those margins should be identical but only that the amount of leverage available in the various markets should be consistent; performance and maintenance margins should be set at levels to equate to the leverage relative to the risk of these securities.

In connection with a matter unrelated to the equity markets, the NASD has observed a growing problem with abusive sales practices involving U.S. Government securities. Currently the NASD lacks the authority to deal with such problems unless it can be demonstrated that they are so serious as to constitute fraud. We are currently exploring with the Treasury Department possible amendments to the 1986 Government Securities Act that would extend our regulatory authority to include such practices within our disciplinary process.

S 2256 Intermarket Coordination Act of 1988 and Domestic Coordination

S. 2256, the Intermarket Coordination Act of 1988 would, if it had become law, provided an Intermarket Coordination Committee made up of the SEC, CFTC, and the FRB. It would have met quarterly under the aegis of the FRB, which would serve as the lead coordinator. It would seek to link the federal regulators in recognition that the markets they were regulating were already linked, and would have implemented a major recommendation of the Brady Report.

Since economic substitutability exists between the derivative instrument and the underlying security, those derivative instruments can obviously affect and be affected by the underlying asset and should both be regulated by the same agency. We do not believe, however, that there is a need now to create by legislation a structure that already exists as the President's Working Group. That Group has responded to many of the problems presented by linked markets, and provided the necessary coordination for joint consideration of the issues. In addition to its report, it also has given staffs of the regulatory agencies working contact with one another that did not previously exist. We see no need to supplant this Group, established by Executive Order 12631, since its authority has not been rescinded, and there is no evidence that a legislatively commissioned interagency body would address problems in a significantly different manner.

In fact, there has been significantly more coordination and cooperation between regulators and self regulatory organizations in the past eighteen months since the market break, in recognition of the interrelationship of markets regulated by different entities.

The NASD takes part in a number of cooperative efforts with other self regulatory organizations. The Intermarket Surveillance Group, for example, is made up of the New York, American, Boston, Philadelphia, Cincinnati, and Pacific Stock Exchanges and the NASD and the Chicago Board Options Exchange. This association of self regulatory organizations was formed in the late 1970s to facilitate intermarket surveillance and regulatory cooperation. In addition to providing a forum for surveillance staff from various markets to meet to improve detection capabilities, it regularly receives input from the SEC's Divisions of Market Regulation and Enforcement. Its accomplishments include the development of:

- The Central Collection and Reporting System, a facility for the daily exchange of information on trading in intermarket securities i.e., options and equities that are traded in more than one market.

- The Large Option Position Report, an automated system for the routine reporting of information on the identity of owners of large options positions.

- The Unusual Activity File, a database of accounts that have traded in an unusual manner.

- The Electronic Blue Sheets, a method for firms to electronically report, on request, information on customer and proprietary transactions.

In response to the recommendations contained in the Brady and SEC market break studies, the heads of the New York, American, Boston, Midwest, Pacific, and Philadelphia stock exchanges, the Chicago Board Options Exchange and the NASD now meet quarterly to discuss issues confronting the marketplaces and their regulation. Additionally, open communications lines have been established between these marketplaces to allow prompt communications on surveillance, market conditions and other significant issues.

S. 2256 Intermarket Coordination Act of 1988 and Foreign Coordination

Section 5(b) of S. 2256 would have, if enacted, required the Intermarket Coordination Committee to discuss the international issues of enhancing market information exchanges, and coordinating regulatory activities.

While securities markets and information exchange and regulatory coordination in the international arena can always be improved, important strides have been taken in recent years.

International regulatory cooperation initially addressed securities fraud. In 1973 the Treaty on Mutual Assistance in Criminal Matters Between the Swiss Confederation and the United States was signed to provide broad assistance in criminal matters in locating witnesses, producing business records, and serving documents. The treaty became effective in 1977. Three other mutual assistance treaties exist with the Netherlands, Turkey, and Italy. Five other treaties have been negotiated, but are not yet effective with the Bahamas, Colombia, Morocco, Canada, and the Cayman Islands.

The SEC has entered into Memoranda of Understanding, which provide assistance in cases of insider trading and other securities frauds, with Switzerland, the Japanese Ministry of Finance, the provincial Canadian securities commission of Ontario, Quebec, and British Columbia, the Brazilian Commission de Valores Mobiliarios, and the United Kingdom's Department of Trade and Industry.

The information linkage between the U.S. and the United Kingdom has significantly expanded regulatory cooperation, with SEC approval and review. In April 1988 NASDAQ became the first market to be granted status as a "Recognized Overseas Investment Exchange" by the Department of Trade and Industry. When it granted "recognized" status to NASDAQ, the Department of Trade and Industry determined that the NASDAQ market has investor protection standards equivalent to those required of domestic United Kingdom exchanges.

The NASD and The Securities Association (TSA) in the United Kingdom are exchanging information about registered securities personnel in their regulatory records. TSA has instant on-line access to NASD records of U.S. registered representatives, and the NASD can check on United Kingdom representatives who want apply for U.S. registration. The NASD is currently working on a similar agreement with the United Kingdom's Department of Trade and Industry.

The NASD, the SEC and other U.S. and United Kingdom regulatory and self regulatory organizations have also entered into a Memorandum of Understanding with the United Kingdom's Securities and Investments Board. This memorandum establishes the exchange of information on the operational soundness of U.S. firms in the United Kingdom and United Kingdom firms in the U.S.

The NASD has also entered into agreements with the International Stock Exchange and the Stock Exchange of Singapore to cooperation in sharing regulatory information for purposes of surveillance and investigation on securities on which quotations are exchanged.

Thus while international regulatory cooperative efforts can always be improved, they are not without precedent, and are increasing as the markets become more linked.

The Group of Thirty Report, "Clearance and Settlement in the World's Securities Markets"

The NASD is keenly interested in the Group of Thirty Report, and is working closely with the U.S. participants.

The NASD endorses the general goals contained in the Group of Thirty Report, which in essence are to compress the clearance, settlement and payment time, to promote efficiency in the systems, and to reduce risks for all participants. The recommendations of that Group set forth the requirements for individual clearance systems to form the foundation of international linkages. The current U.S. system already meets most of the recommendations of the Report. The U.S. securities markets have been leaders in clearance and settlement efficiency, and improvements are being made constantly. Notwithstanding the fact that the U.S. may lose some of its competitive advantage in the clearance, settlement and payment process, and will incur costs in implementing the recommendations, the reduction in risk and the efficiency to be achieved in the process will more than outweigh any loss in competitive advantage or cost of implementing the recommendations.

The NASD agrees that effective, efficient, and reliable clearance and settlement systems -- while perhaps not the most glamorous aspect of international trading -- are the essential foundation on which the international market must be built if it is to properly serve global investors.

Major deficiencies found by the Group of Thirty in the clearing systems were the risks presented by the absence of compatible trade comparison (or confirmation and matching) systems for domestic and international trades; different settlement periods; the lack of delivery versus payment, which leaves one or the other party unduly exposed; the lack of standard trade guarantees; and the absence of book order processing for settlement.

The Report's nine recommendations to alleviate these risks include shortening the time between trade date and settlement, promoting trade guarantees, and assuring the simultaneous exchange of payment and securities. Efficiency of the process can be enhanced by eliminating the physical movement of securities, encouraging appropriate netting systems, and standardizing communications and settlement schedules.

While we support the goals of the Group of Thirty Report, we caution that the impact on the participants must be carefully studied, and particularly the impact on the individual investor, who is continuing to be a key participant in the U.S. equity markets.

Challenges to the U.S. Securities Markets

The major challenge facing the U.S. securities markets will be -- as it has been in the recent history of those markets -- to balance the pressures presented by automation and internationalization with the need to maintain high standards of investor protection, particularly for small investors, who individually are less equipped to protect themselves.

Automation Automation is permeating every aspect of every financial market. Automation has totally reshaped the financial markets in the past 20 years. In 1971, NASDAQ's automated quotation network transformed America's over-the-counter market, and with it the workdays of thousands of securities traders and support personnel. Other markets have followed the NASDAQ's lead into the electronic age: London with the SEAQ system, Toronto with its CATS system, Singapore's SESDAQ automated quotation system, and Japan recently decided to automate its over-the-counter market along NASDAQ lines. The vast majority of securities listed on the Tokyo Stock Exchange already trade through automated systems rather than on the floor. Other markets in Europe, East Asia and South America are also announcing plans to automate their markets along the lines of NASDAQ, a dealer quote driven system or CATS, an order-driven system.

Automated order routing, and increasingly execution and post-execution processing, is now a necessity to process the increased volume of business. The Dot and SuperDot systems allow the New York Stock Exchange to handle its order flow and keep the specialists from being overwhelmed.

Automation's impact is also evident in the proliferation of products that have flourished in recent years -- options, futures, arbitrage, and the securitization of most forms of collateral; however, it has also impacted the mechanics of the markets themselves. Automated trading strategies are now almost universally in place to guide buy and sell decisions in the options and futures markets, as well as in the cash markets.

The new technology of the Globex system being developed by the CME and Reuters has the potential to create a 24-hour futures market -- a development that is bound to have repercussions in securities markets. Indeed, the CBOE and the Cincinnati Stock Exchange recently announced their interest to work with Reuters to develop off hours trading capabilities for U.S. equities.

Internationalization Foreign banks have established securities affiliates in this country to take advantage of capital market opportunities here. There are, in fact, more than 50 securities affiliates of overseas banks and international securities firms who are members of the NASD, many of which not only make markets in NASDAQ securities but engage in a wide range of investment banking activities.

U.S. banks and securities firms participate in capital markets abroad. More than 50 U.S. securities firms registered with the NASD have branch offices in other countries, with international operations accounting for growing percentages of their total revenue.

Effects on the NASDAQ Market NASDAQ is the product of the electronic age and has remained a leader in the use of electronic- telecommunications quotations and trading systems. NASDAQ proved that it was possible to bring geographically dispersed broker-dealers together on a real time basis through an electronic market system with economic efficiencies and regulatory protections at least the equal of traditional floor-based exchange markets.

With automation came further advances, such as the capacity the NASDAQ market has to automatically execute orders of 1000 shares at the best available price through SOES. New services automate much of the order-entry, execution and post-execution process, yet allow for negotiation in larger trades. These systems, which bypass the telephone, increasingly make NASDAQ a market of direct computer-to-computer communications between participants. Screen-based trading technology has proven to be an ideal avenue for a quotation driven market of competing dealers. It is perhaps no coincidence that the NASDAQ market now has more competing market makers, making more markets in stocks than ever before. They are providing liquidity to investors fairly and efficiently, on a continuous basis, interrupted only occasionally by trading halts in individual companies for the release of material information.

In an increasingly international trading environment, the trend toward automation can be expected to continue. There are several advantages to investors in gaining access to the international markets through a screen-based electronic system with competing dealers. These include: competitively determined bid/offer prices that quickly and accurately reflect market conditions; providing the most efficient price discovery mechanisms; providing greater second by second liquidity for all stocks on a continuing basis; and providing ready access to other markets with similar automated capabilities. For example, it was a relatively uncomplicated matter to devise information linkages between NASDAQ and London's SEAQ system, which was modeled on NASDAQ. We anticipate that linkages with other automated quotation systems, can also be relatively easily accomplished.

A major advantage of automated markets is that they can be more effectively regulated. On-line market surveillance creates an electronic window through which trading activity can be monitored, providing better information exchange with other markets and overseas regulators. The NASD is seeing the benefits of this regulatory capacity through an exchange of regulatory'information with our counterparts in London. The challenge is to ensure that the increased use of automation in surveillance and monitoring keeps pace with the proliferating uses of automation by the participants in new trading methods and instruments.

Federal Regulatory Resources and Authority

While we believe that the SEC has the requisite legislative authority to deal with another market break situation, it is equally clear from the limited growth of SEC staff that the SEC has not kept pace with the growth under their jurisdiction. The SEC has severely constrained resources to deal with normal circumstances, much less periods of market crises, like that of October 1987. The resources of the various divisions at the SEC, which have grown little in recent years, have not kept pace with the demands placed on them by the markets:

- Enforcement Division - Since 1982 sales on U.S. securities exchanges have more than doubled to $1.8 trillion, and complaints to the SEC have climbed by 230%.
- Market Regulation Division - Since 1980, registered broker dealers have increased 88%, and registered representatives have increased by 145%.
- Corporate Finance Division - Since 1980, there has been a 135% increase in the number of registration statements filed, and an 175% increase in the merger proxies filed.
- Investment Management Division - Since 1980, registered investment companies have increased 146% and the registered investment advisers grew by 217%.

The NASD supports increased fiscal and staff resources for the SEC, but recommends that these resources come from general fund appropriations rather than be tied to SEC fee collection. The fees collected from the securities industry by the SEC were originally meant only to cover the costs of the regulation but are now paying more than twice the annual cost of that agency. Moreover, the economy and taxpayers at large benefit substantially from the efficient capital markets that the SEC polices, and so should continue to pay for that regulation out of general tax monies. Finally, fee collection tends to increase during economic growth, but decrease during economic shrinkage, just when there is a substantial risk of fraud that must be countered with alert, adequate regulation.

In summary, we believe that the NASD has taken actions to prevent the important problems that NASDAQ experienced during the market break of 1987. The NASD supports the provisions of S. 648 for coordinating clearance and settlement among the equity and derivative markets, but questions the need -- unless a greater demonstration of need can be made -- for those provisions on large trader reporting and holding company risk assessment, and opposes provisions relating to trading halts. We think that the remaining problems are now being well addressed by the joint efforts of the regulators, the self-regulators, and the industry, and that legislation will unnecessarily limit the flexibility necessary to respond to market conditions as they develop. Indeed, this flexibility permitted the markets to continue, open and operating, during the market break, preventing an even greater uncertainty and loss of investors confidence. We see the greatest challenges to the U.S. securities markets to stem from responding to pressures of automation and international competition while maintaining the high standards of investor protection we all endorse for our markets, particularly for small investors, who individually are less equipped to protect themselves. Finally, we believe that the SEC should receive additional appropriations from general fund monies, not from fees.

Thank you very much for this opportunity to address you, and I am prepared to answer any questions you may have.

APPENDIX A

1987-1989

NASD AND NASDAQ STEPS TAKEN TO RESTORE INVESTOR CONFIDENCE

A CHRONOLOGY

- **November 16 — NASD Proposes Mandatory Participation in Computer-to-Computer Execution System.** NASD's Board of Governors proposes changes aimed at providing investor access to NASDAQ in all market conditions. To bypass the telephone, NASDAQ would mandate participation by NASDAQ's 540 market-making firms in NASDAQ's computer-to-computer execution system (SOES) for trades up to 1,000 shares.

- **January 5, 1988 — NASD Introduces Automated System to Handle Trades as Large as 100,000 Shares; NASDAQ Workstation Unveiled.** The Order Confirmation Transaction (OCT) System extends the potential for automatic execution and telephone bypass to virtually all trades, including negotiated transactions up to 100,000 shares. NASD also formally introduces Generation-3, the new PC-based workstation, which will enable market makers to better allocate capital in fast-moving markets.

- **January 8 — Presidential Task Force Chaired by Brady Issues Report on Market Break; Finds NASD "Took Swift and Dramatic Action."** The Task Force notes that if the proposed reforms in SOES had been in effect, most of the problems in executing small orders could have been avoided.

- **January 15 — NASD Receives Temporary Approval to Implement New NASDAQ System Enhancement.** The SEC grants preliminary approval of the OCT System allowing negotiated large NASDAQ trades to be conducted over the computer, without telephone contact.

- **January 22 — NASD Board of Governors Approves Measures to Improve Investor Access, Strengthen Market Maker Commitment.** Board approves changes to SOES, including mandatory market maker participation, continuous operation under all market conditions, and creation of affirmative obligations for market makers. Board establishes a 20-business-day suspension for market makers who withdraw from making a market in a security.

- **April 12 — Regulatory Review Task Force Publishes Findings and Recommendations.** Among the recommendations made by the Task Force are to establish minimum standards to restrict the flow of sensitive information to deter insider trading, to further automate NASD's market surveillance, to disclose disciplinary histories of brokers, and remove ceilings on disciplinary fines.

- **May 3 — NASD Increases Investor Information About Stockbrokers.** Under the new policy, NASD member firms and their affiliates will be required to disclose more fully past disciplinary actions involving individuals doing business with the public.

- **June 14 — SEC Approves Changes to SOES.** The SEC approves the NASD proposal to ensure investor access to NASDAQ in all market conditions. In addition, the new rules establish minimum market maker commitments for each bid or offer displayed, based on the trading characteristics of each security. The limits are 1,000 shares for nearly 2,000 of the most actively traded National Market System securities, 500 shares for some 600 less active issues, and 200 shares for the least active NASDAQ/NMS securities, which number approximately 400.

- **June 23 — NASD Seeks Formal SEC Approval For a Plan For an Electronic Bulletin Board For Price Quotations and Indications of Trading Interest by Market Makers in Non-NASDAQ OTC Securities.** The non-NASDAQ OTC market, often termed the "pink sheets," embraces some 20,000 to 30,000 stocks, many of which trade under an SEC exemption from registration.

- **June 28 — NASD Seeks Formal SEC Approval for a NASDAQ-type System For the Trading of Unregistered Securities of Major Domestic and Foreign Issuers by Financial Institutions and Individual Investors With Substantial Net Worth.** The system is named PORTAL, for Private Offerings, Resales and Trading through Automated Linkages.

- **July 1 — NASD Implements SOES and Regulatory Changes.** Changes to NASDAQ's computer-to-computer execution system go into effect.

- **July 1 — NASD Files with the SEC Proposals for Improving the Association's Arbitration Program.**

July 11 -- Trading Halts in NASDAQ Securities Become Effective after SEC Approval. They replace the prior quotation halts, and afford investors more protection.

- **July 22 — NASD Quality of Markets Committee Submits Comprehensive Report to NASD Board.** Report includes many important recommendations for improving the NASDAQ market. Study also proposes a congressionally sponsored study of U.S. securities markets.

- **July 27 — Survey Shows Individual Investors Are Optimistic About Financial Prospects But Conservative About Markets.** A survey of 1,000 individual investors, commissioned by the NASD and conducted by Opinion Research Corporation, found that nearly two-thirds of those surveyed remain long-term investors and are positive about the economy and their own financial prospects. But more than 60% said the markets are riskier today for individual than only a year ago; 81% said that stock index options and futures contracts have made it more difficult to understand the marketplace.

- **August 1 — NASD Seeks Formal SEC Approval for Higher National Market System Standards.** Upon SEC approval, NASDAQ/NMS standards will equal or exceed Amex standards in every area.

- **August 9 — The SEC Approves the NASD's Rule Change Requiring NASDAQ Companies to Notify the NASD of Material News Announcements Prior to Their Release to the Public.** The amendment recommends that issuers notify the NASD of material news at least 10 minutes in advance. This makes trading halts more effective.

- **October 3 — In restating its opposition to so-called circuit breakers, the NASD calls for aggressive action on a series of initiatives it believes would serve as more permanent and appropriate solutions to any future market break.** As an interim step, the NASD says it will accede to requests from the SEC to halt trading in markets under its supervision.

- **October 3 — Market Makers Begin Mandatory Reporting to NASD Market Surveillance of Significant Transaction ($10,000 or 50,000 Shares) in Non-NASDAQ Securities.**

- **October 13 — SEC Approves Amendments to the Rules of Fair Practice Prescribing Specific Supervisory Practices and Procedures for All NASD Member Firms.**

- **October 24 — The NASD and the Securities Association (TSA) of the U.K. Announce an Agreement to Share Information on the Employment, Qualifications, and Disciplinary Histories of Professionals Registered With Both Organizations.**

- October 28 — Additional Improvements to the NASD's Arbitration Code are Filed With the SEC.

- **December 13 — The SEC Unanimously Approved NASD Rules Forbidding the Use of SOES by Professional Traders for Their Own, Their Members', and Their Firms Accounts.** The rules define "professional trader and "day trading."

- **January 6, 1989 — The SEC approved the NASD's new initial and maintenance standards for NASDAQ/NMS listing.** The standards are equal to or exceed the American Stock Exchange's standards in every way.

- **January 20 — NASDAQ starts SOES Limit-Order File for the benefit of individual investors.** The Limit-Order File allows individuals to place SOES orders that are away from the inside market. Stocks were phased in between January 20 and March 31.

- **January 26 — NASD submitted for SEC approval a proposed rule that would extend its prompt receipt and delivery rule on short sales to proprietary short sales of broker-dealers excepting registered market makers and fully-hedged positions.**

- **April — NASD announces that Automated Confirmation Transaction (ACT), an on-line trade confirmation service, will begin in mid-summer.** The service will improve the risk management capabilities of market participants by reducing exposure to price movements; provide faster, more efficient trade confirmations; and reduce clearing risk and expenses.

- **May 2 — NASD issued a new regulation designed to guarantee delivery of stock purchased from short sellers for the accounts of public customers.**

- **May 10 — SEC approved arbitration rule changes.** The changes that affect individual investors include: more restrictive definition of securities industry arbitrator; public disclosure of awards; and expanding the availability of single-arbitrator decisions to disputes with public customers up to $30,000.

Senator DODD. Thank you, Mr. Hardiman.
Mr. Melamed.

STATEMENT OF LEO MELAMED, CHAIRMAN, EXECUTIVE COMMITTEE, CHICAGO MERCANTILE EXCHANGE

Mr. MELAMED. Thank you, Mr. Chairman, and members of the committee. I appreciate this opportunity to respond to your inquiry, and in a way to relive those moments in 1987 that we would rather forget, but that certainly taught us a great deal.

At the outset, I would like to compliment this committee for its prudence and foresight during those conditions in 1987. You will recall there was a great deal of panic, a great deal of accusatory and often inflammatory language, that would have rushed those with less prudence than this committee to a quick judgment or quick legislation. None of that happened, fortunately.

The markets were allowed to adjust, the markets were allowed to react, the markets were allowed to find the way back to normalcy and to correct whatever had to be corrected. A great deal of credit is owed to this committee, for having the prudence and foresight in those days to understand that markets can find their way, and that one should not react with panic-type legislation.

One of the questions you asked that we respond to, Mr. Chairman, is the nature of our international stance in terms of these markets. Senator Gramm correctly stated that our market is the jewel of the American system that has provided us with a standard of living that is the envy of the rest of the world.

That is of great concern to all of us, that we not lose that jewel or any portion of it. I believe our market has shown a great deal of direction and leadership. Indeed, we recognized as early as 1987, prior to the crash, that international competitive forces resulting from technology and technological changes, demanded that we protect the innovations of our marketplace and not permit them to be usurped or taken over by either the Japanese or European communities.

In that respect, as you know, we developed and are continuing to develop an after-hours global electronic transaction system for futures and options. Called Globex, the system will be instituted in October of this year. And we have partner exchanges: the MATIF in Paris, the Sydney Futures Exchange, and the New York Mercantile Exchange. These three exchanges have already joined Globex. We are currently negotiating with other domestic and foreign exchanges. We expect other exchanges to join that system in providing the world with around-the-clock, 24-hour coverage in futures and options markets. I believe that would go a long way toward answering some of the concerns that arose as a result of the October crash, because we learned from the crash how connected markets are.

Let me also at this juncture mention the fact that Senator Wirth may have given the view that it was the futures market that instituted the crash in the United States. Well actually, the crash was a global event that was experienced all over the world.

The crash occurred not just in the United States, and it did not begin here. The events occurred in other areas of the world, even before they happened here. Indeed, world market are interconnected.

Since the time of the crash, the Chicago Mercantile Exchange has done a great deal both to strengthen from within and in coordinated efforts with other exchanges. The testimony that I already submitted for the record details the strongest part—that there has been cooperation and coordination between the members of the private sector. These coordinated actions count to a degree that we have never seen before.

Truly, we instituted an historic agreement between the Chicago Mercantile Exchange and the New York Stock Exchange. We coordinated a truly unprecedented agreement to protect our markets from disconnecting such as occurred on October 19th and 20th.

This historic agreement provides a five-stage circuit-breaker program, which allows the market to pause and evaluate the rapid flow of information. And while none of us want the market to close, and certainly don't want it to close for very long, we all recognize that October 1987 taught us that we should give market users a moment to digest the flow of orders and news during a panic condition. And as Mr. Phelan correctly stated, none of us can predict what yet lies ahead of us in the markets.

The first stage of these circuit breakers, in fact, recently came into effect. On that day, at the Chicago Mercantile Exchange, the five-point opening price limit of that program went into effect. I must say that it operated in perfect fashion. It caused no rippling effect, and no transference of an unbalance anywhere. As a matter of fact, it aided in balancing the market for the 2-minute halt that occurred at the Chicago Mercantile Exchange.

Everything went the way it was supposed to, and indeed all observers lauded the procedure. It was a small test, but it went very, very well. Hopefully, no other triggers will occur, but the first signs from the plan have been positive.

As far as the actions, the many other actions that the Chicago Mercantile Exchange instituted, I will leave that for my written testimony, as part of this record.

I would be glad to answer questions pertaining to the proposed legislation. Thank you very much.

[The complete statement of Leo Melamed follows:]

TESTIMONY

OF

LEO MELAMED

CHAIRMAN OF THE EXECUTIVE COMMITTEE AND SPECIAL COUNSEL TO THE BOARD OF GOVERNORS

CHICAGO MERCANTILE EXCHANGE

BEFORE THE

SUBCOMMITTEE ON SECURITIES OF THE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

MAY 18, 1989

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Mr. Chairman and Members, good morning. My name is Leo Melamed. I am Chairman of the Executive Committee and Special Counsel to the Board of Governors of the Chicago Mercantile Exchange (CME). Accompanying me this morning are John T. Geldermann, Chairman of the Board, John F. Sandner, Special Advisor to the Board, and William J. Brodsky, President of the CME. We welcome this opportunity to appear before this Committee to address the October 19, 1987 world stock market collapse and the after-effects of that phenomenon.

At the outset, allow me to compliment this Committee for the foresight and prudence it exhibited in the weeks following the frightening events of that October. It should serve as a model lesson to all Congressional committees and members of the Congress.

Amid the near-panic conditions which then pervaded the media, amid the calls for market reforms by many, amid outlandish statements and irresponsible accusations by some who pointed in one or another direction for the perceived cause or culprit of the crash, this Committee retained its composure, refrained from any emotionally dictated reaction, and was not panicked into any unwarranted legislative action. Any legislative response would have been misplaced, counterproductive, and would have interfered with the marketplace to its ultimate detriment.

Nearly one year ago, this Committee heard testimony from the White House Working Group[1] which analyzed the events of the October 1987 Crash and clarified the Brady Report recommendations on clearing and settlement procedures, information flows, margin requirements, financial safeguards and cross-market circuit breakers. These intricate and complicated areas prompted Chairman Greenspan to advise this Committee that "The most important result of the crash is that market participants learn and act. They have done so and are doing so."

Mr. Chairman, members of the committee, I would like to briefly highlight for you the steps the CME has taken regarding the White House Working Group and Brady Commission recommendations. The improvements I will review today were implemented for the most obvious reason of all--they serve the customers of all exchanges.

I. COORDINATED POST-CRASH EFFORTS

All of the studies recognized the interplay among futures, options and securities exchanges. Many suggested a system of circuit breakers or shock absorbers that could be applied across all markets to help prevent another free-fall such as occurred on October 19. The Chicago Mercantile Exchange has instituted a wide range of such initiatives.

A. The CME and the NYSE negotiated a five-stage circuit breaker program which functions in the following manner:

1. A five-point opening limit on the Standard & Poor's 500 futures contract which applies for the first 10 minutes of trading. (5 S&P points equal roughly 40 Dow Jones Industrial Average (DJIA) points.)
2. A 12-point price limit (equal to approximately 100 DJIA points) will remain in effect for 30 minutes from the time the price limit is triggered.

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[1] Alan Greenspan, Chairman of the Federal Reserve Board of Governors; George D. Gould, Undersecretary of the Treasury for Finance; David S. Ruder, Chairman of the Securities and Exchange Commission and Wendy L. Gramm, Chairman of the Commodity Futures Trading Commission.

3. **Once the CME's 12-point limit is triggered, the NYSE will institute a new procedure to divert "program trades" to a separate computer file. That diversion will temporarily alleviate market pressure that may arise. If a stock is found to have an order imbalance of greater than 50,000 shares, the NYSE will halt trading in the stock and publicly announce the imbalance. The stock will reopen when the imbalance is alleviated.**

4. **Both exchanges have instituted price limits, of 30 S&P points and 250 DJIA points, respectively. The CME limit will be transformed into a coordinated one-hour trading halt if the DJIA drops 250 points.**

5. In a coordinated reopening procedure, the S&P futures contract will resume trading following the one-hour halt once 50 percent of the capitalization-weighted value of the stocks in the S&P 500 index have reopened on the NYSE. After the reopening, the CME and the NYSE will allow market trading to the extent of another 20 points on the S&P and 150 DJIA points. If this last step is reached, there will be a coordinated two-hour trading halt.

The first of the foregoing stages was invoked for the first time on March 17, 1989 when an unfavorable producer price report sent the DJIA tumbling 48.57 points lower on the day; an approximate 2% daily decline. Opening stock and futures selling quickly triggered the five-point opening limit. Futures trading halted for two minutes, then resumed. The market decline did not trigger any other circuit breaker stages in the process. Market watchers unanimously praised the process for giving markets the time to digest and analyze the news of that morning before selling off further.

B. The CME and NYSE agreed upon a unified definition of inter-market frontrunning.

C. The CME and NYSE established appropriate surveillance procedures and the exchange of information necessary to enforce compliance.

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E. The CME developed a cross-margining system with the Options Clearing Corporation (OCC).

F. A "hotline" linking officials at futures, options and securities exchanges has been established to insure immediate, direct communications in times of unsettling market activity.

G. Standardized bank settlement agreements between clearing firms and all settlement banks have been established. The agreements establish the terms of settlements and payments between the banks and clearing firms. They eliminate ambiguities in this area.

H. A clearing organization/Clearing Bank Roundtable has been established and is now conducting regular meetings to discuss matters of common interest and concern to its members.

I. The CME, in cooperation with other futures exchanges, is working toward a futures-style margining system for options. A proposal in this area has been put out for public comment by the CFTC. We believe that futures-style margins for options would improve the operational efficiency of the margin system as well as aid capital flows in the market.

J. The Intermarket Financial Surveillance Group, consisting of representatives of all domestic securities and futures exchanges, has been established to monitor the financial health of clearing members.

K. The Intermarket Surveillance Group, created at the direction of the SEC, is working to define intermarket trading abuses, devise an effective surveillance system and assign surveillance responsibility. This group is comprised of all security and security options exchanges. The CME and other futures exchanges that trade equity indices participate in the meetings. The CME is discussing affiliate status.

II. CME POST-CRASH ACTIONS

In addition to the cross-market efforts outlined above, the CME has instituted a number of internal measures in response to October 1987.

A. Institution of a portfolio-based margining system (SPAN). This system, implemented following CFTC approval on December 16, 1988, evaluates overall risk in a portfolio and matches dollar margin to portfolio risk more accurately than ever before. The CME is working toward establishing this system as an industry standard. Already, the Coffee, Sugar and Cocoa Exchange has adopted SPAN. Other exchanges are considering it.

B. Institution of regular intraday mark-to-market of positions with pays and collects. This, in effect, marks traders positions to markets twice a day, once during trading hours when banks can more easily make credit decisions and transfer necessary collateral accordingly, and once at the close of trading.

C. A nearly 10-fold increase to more than $30 million in the size of the pool of security deposits the Exchange can look to in the event of a default. The Exchange also has decided that letters of credit will no longer be acceptable as security deposits.

D. Negotiation of a $125 million primary line of credit with the Exchange's major banks. The primary line represents half of a $250 million unsecured, committed credit facility the CME has in place with its major banks. The primary line can be used in the event of a default of one or more CME clearing members or in the event of a money gridlock in the market.

E. Development of a new trade order processing system (TOPS) that will greatly facilitate order flow to our trading pits.

F. Persistent monitoring of margin levels for S&P 500 futures. The CME continuously monitors all margins to ensure the sound prudential purpose is met. No customer has ever lost a penny due to a margin default and we will maintain that record. The present initial margin level of $6,500 and $4,000 maintenance margin is much higher than levels dictated by any industry-accepted risk-analysis program. However, we think it a prudent level to maintain public confidence in our market.

III. SUMMATION OF POST-CRASH ACTIVITIES

Inter-exchange coordination has reached unprecedented levels since October 1987. Such coordination will only increase. Areas of inter-exchange concern have been addressed thoughtfully and thoroughly by the various industry working groups now in place. Each exchange has moved quickly and decisively to address concerns unique to its organization and particular markets.

Regulators of both futures and securities better understand the other markets, acknowledge the distinct differences between the two, and the needs for independent analysis and regulation of particular concerns of each industry, and are cooperating extensively.

One of the areas of greater understanding is margins. There is now an important recognition that the smooth flow of capital depends on efficiently set margins, action that can be taken only by the respective exchanges. Indeed, an August 1988 report by the House Banking Committee noted that "The fact that prices are jointly determined on both markets (futures and equities) offers no reason...to 'harmonize' margins by federal fiat. The Committee concluded: "Federal regulation of margins would serve no good public purpose, and would likely prove futile and counter-productive by leading to a regime of margins too costly and too inflexible for the efficient functioning of broad and liquid markets." House Banking Committee Print 100-6, Report on the Regulation of Futures Margins, August 1988.

Moreover, as a consequence of the comprehensive analysis conducted after the 1987 crash, it has become widely understood that the differences between the role, function and level of futures and stock margins exist as a natural and necessary result of the very different functions these two markets perform. The are not the result of a regulatory gap or loophole.

Reliance on reasonable and safe margins established by the exchanges, as well as improvements such as the CME/OCC cross margin agreement and futures-style margins for options, should continue to improve the integration and efficiency of our markets.

The present regulatory structure has proved capable of addressing the issues highlighted by the Crash and of instituting responsive changes. We see no signs of any "gaps" in regulatory oversight, no unnecessary duplication of oversight, nor any need to consider a consolidation of government regulation of the futures and securities industries.

IV. VIEWS ON PENDING LEGISLATION

This Committee has before it four pieces of proposed legislation requested by the Securities and Exchange Commission. While most of these proposals deal solely with the securities markets, there are a few provisions that would directly affect the futures industry.

While these provisions will not be discussed in detail, some discussion is needed to point out jurisdictional overlaps, costly regulatory duplication and new regulation directed at problems that the CME and other exchanges have either eliminated or substantially alleviated through self-regulatory action.

Market Reform Act Of 1989

On March 17, 1989, Senators Dodd and Heinz introduced the Market Reform Act of 1989 (S. 648) which has four separate sections.

1. SEC Emergency Authority to Halt Trading.

This provision would not directly affect futures markets since the SEC's authority would be limited to markets under its regulation. We think it appropriate that the SEC be granted powers equivalent to those that the CFTC has long held.

2. Large Trader Reporting.

The SEC's commentary on this provision explains that it is modeled after the large trader reporting authority of the CFTC. Indeed, large futures traders have been required to file reports with the CFTC for some time. However, the SEC proposal is not limited to securities transactions. It extends to large stock index futures traders as well.

Our concern, therefore, is two-fold. First, this provision would authorize the SEC to intrude on the CFTC's jurisdiction. Such jurisdictional overlap would cause confusion over which agency has responsibility for market supervision and could result in unproductive friction between the agencies.

Second, there is no need to impose additional reporting requirements on stock index futures traders. The current CFTC reporting system is sufficient for large futures traders. The SEC can obtain whatever information it needs from the CFTC without requiring futures traders to file their reports with the SEC as well as with the CFTC.

If such dual reporting were mandated, which we feel would be costly duplication, then the contents of the reports should be the same for each agency. Unnecessary expense would again result if different reports had to be filed in each agency with respect to the same transactions.

Finally, we wish to sound a note of caution in this general area. Reporting requirements often represent an intrusion into the private affairs of investors; whenever these investors have alternative foreign markets within which to execute their business without governmental reporting demands, they will elect to do so. In the present global competitive environment, we must be ever careful not to unnecessarily deter the investor from U.S. markets.

3. Risk Assessment for Holding Company Systems.

This provision would authorize the SEC to require futures traders (along with various financial institutions) associated with SEC-registered brokers or dealers to file financial reports with the SEC. However, an exception is provided if substantially similar information is reported to the CFTC. The practical implications of this reporting requirement for the futures industry are not clear, but we again are concerned that jurisdictional overlap and duplicate reporting will result.

We believe that all futures trader reports should be subject to CFTC jurisdiction. The CFTC can then make information and reports available to the SEC. This is another area in which consultation and cooperation between the SEC and CFTC is preferable to new SEC authority over the futures industry.

4. Linked, Coordinated or Centralized Clearing.

This provision raises many problems. Our extensive study of the centralized clearing concept indicates strongly that such a change would hinder rather than improve the ability of the financial system to respond to market disturbances.

First, to the extent that this proposed legislation is directed only at "linked" or "coordinated" clearing, rather than strict centralized clearing, it is already behind the times. In the wake of October 1987, the CME and other major exchanges have taken voluntary action to strengthen their own clearing systems and to coordinate their clearing systems with one another (highlighted previously).

In short, we agree that there is a need for linked and coordinated clearing, but we disagree that the best manner of achieving that result is through legislation.

The exchanges understand the practical problems involved and are best placed to improve their systems. We would encourage Congress to monitor these self-regulatory improvements, but not to take action that may cause other, long-term problems. For instance, we strongly oppose any centralized clearing system for all securities, options and futures transactions for numerous reasons.

One of the great strengths of the current clearing systems is their diversity and adaptability to the unique characteristics of each exchange and trading system. A unified clearing system would lose this adaptability and close fit to the needs of the particular exchange or market. We also fear that a "least common denominator" effect will take place and that clearing rules useful or even essential to futures transactions will be discarded if they do not fit the needs of securities transactions.

We take great pride in the innovations that have occurred in the futures industry in general and at the Chicago Mercantile Exchange in particular. A unified clearing system, however, will be a substantial step away from such innovation because it will remove the competition among exchanges and markets that has inspired innovation.

Finally, we do not believe that a centralized system will increase cost efficiency through economies of scale. Instead, the lack of competition and the loss of innovation will most likely increase costs.

It is critical for this Committee to review and understand substantial reforms that have been undertaken voluntarily by the CME, the futures industry and other exchanges and markets before imposing unnecessary and even counterproductive market changes.

Our review of the other legislation requested by the SEC -- International Securities Enforcement Cooperation Act of 1989; Securities Law Enforcement Remedies Act of 1989; and Shareholders Communications Improvement Act of 1989 -- indicates that none of it pertains to the futures industry or intrudes into CFTC jurisdiction. If any amendments to the proposed legislation would affect our industry, we request an opportunity to appear and comment on the proposals.

V. CLEARANCE AND SETTLEMENT SYSTEMS

Clearance and Settlement Systems in the World's Securities Markets

We have very carefully reviewed the nine recommendations of the Group of Thirty's Steering Committee as well as the five "working papers" of the Working Committee of that Group. While these recommendations have direct impact on our colleagues in the securities industry, the Chicago Mercantile Exchange believes that a number of points are of universal relevance to the global financial services industry.

Our most important comment on this report is that it is another clear demonstration of the advantages of private sector initiatives in handling complex issues in the financial markets. The Group of Thirty consists of key personnel in top financial institutions of the major nations in the world. To have developed such far-reaching recommendations in such a short time could only be the result of private sector effort. As noted earlier in my testimony, it has been private sector initiatives which are responsible for the significant changes in the financial markets, including changes in clearance and settlement, which have occurred since October, 1987. Congress must realize and appreciate that it is the private sector that is best able to develop and implement the necessary improvements in clearance and settlement. Heavy-handed government intervention will only serve to delay necessary changes and introduce nationalistic political considerations into an environment of international cooperation.

With respect to the specific recommendations, to the extent our expertise extends to these areas we agree with each of them. We particularly applaud the recognition of the need to speed the time between trade execution and trade comparison (Recommendation 1) and the time to settlement, which should be in "same day" funds on a continuous net basis (Recommendations 6 and 7).

It must be noted, however, that while standardizing settlement times in the global equity securities industry to a three-day cycle would be desirable, the futures and futures options markets generally operate on a much tighter timeframe, which should be preserved. The CME and its sister futures exchanges in the United States have been on a next-day settlement system for many years. Most of the futures exchanges which have developed in recent years in foreign jurisdictions are also on that standard. While it would be desirable to adopt a next-day settlement system among all the futures exchanges around the world, it would be completely unacceptable to reduce the safety in the existing system in the name of standardization by implementing the three-day settlement cycle in both global futures and equity securities markets.

We are also most supportive of Recommendation 9, which advocates the standardization of securities message formats across jurisdictions using the formats developed by the International Organization for Standardization (ISO). One of the members of the staff of the CME serves as chairperson for the U.S. chapter of the Securities Message Format Working Group of ISO. This group is working diligently to implement these standard message formats in the U.S. and we will continue to support their efforts. We are also carefully studying the application of these formats to various transactions in the futures industry. In further support of standardization in this area, one year ago we became the first futures exchange in the world to become a participant in the Society for Worldwide Interbank Financial Telecommunication (SWIFT). We will be increasing our utilization of SWIFT formatted messages (which are recognized by ISO) in all aspects of our clearing system. We have also encouraged other futures and securities clearing organizations to become SWIFT participants.

Your final question regards the first steps that need to be taken to improve domestic clearance and settlement. Recognize, of course, that we have already taken a number of steps toward that goal, which I have outlined in the previous sections. You are no doubt aware that the Office of Technology Assessment (OTA) is currently conducting a comprehensive study of clearance and settlement issues in all the financial markets (not just equity securities which was the area covered by the Group of Thirty).

The CME participated in two important aspects of this OTA study. First, we helped design a survey of some 35 questions on clearance and settlement issues which was sent to all major clearing organizations and other major market participants. We have recently completed and returned our survey, and we understand that OTA's subcontractor is currently compiling the results. Second, in our role as expert witness, we have written a paper on "The Challenges of the 24-Hour Financial Marketplace" which will appear in the OTA study along with papers from a number of other experts in these matters. We have also provided comments on some of these other papers at OTA's request.

It is our belief that the OTA study, covering as it does all of the aspects of clearance and settlement across financial markets, will provide a good indication of the appropriate next steps to take in order to continue to improve domestic clearance and settlement and keep it competitive in the global financial marketplace. Let me re-emphasize that these next steps will be taken by the private sector acting swiftly and appropriately to handle the challenges of the future.

VI. INTERNATIONALIZATION OF MARKETS

The most important trend affecting securities markets and capital formation is the acceleration toward international markets. Capital moves across national boundaries with increasing ease, reflecting both enhanced opportunities and sophistication on the part of investors to exploit the opportunities. The Chicago Mercantile Exchange early on recognized the importance of this phenomenon with the development of foreign currency and Eurodollar futures and options. Most recently, the development of our global electronic transaction system, GLOBEX, is a demonstration that not only do the trading instruments need to reflect an international orientation, but that the mechanism of trading must fit in the international community as well.

Steps to keep our economy in a position to benefit from this trend must be made today, or the United States may lose its place of preeminence in the world capital markets. Private U.S. firms have demonstrated an ability to move quickly and effectively in this environment, but regulatory burdens and institutional inertia on the part of some major institutions should be addressed promptly.

Regulation of securities and futures markets internationally has shown little consistency across national boundaries. While regulation should be adequate, great care must be taken that our regulations do not place unnecessary constraints on the U.S. securities and futures industries. Many instruments are traded at several different locations around the world, and regulatory inequities could chase U.S. business to foreign markets.

Institutional change is also needed to keep up with these rapid developments. Traditionally our banking system has been oriented to domestic business, but to remain competitive it is necessary to change. Allowing U.S. banks to hold foreign currency deposits beginning in 1990 is a major positive step, but many more will be necessary. Our central bank now operates during our business day, leaving the important tasks of clearing, settlement and oversight of international monetary flows to other national banks. It is likely that some national bank will expand its activities to cover more of the twenty-four hour span. If the U.S. Federal Reserve moves in that direction first, it would insure that our facilities and policies, which are currently the focus of the entire world, would maintain their dominant role. If another central bank seeks this role, our influence internationally could be diminished.

The last few years have demonstrated the degree to which the markets for securities and futures have become increasingly linked internationally. This is not a trend that is likely to be reversed. Private U.S. companies are very dynamic and capable of adjusting to these challenges. The goal of Congress should be to provide the regulatory and institutional framework that will allow effective competition and to keep the U.S. economic policy role in the forefront of the international arena.

We agree that the regulators of financial institutions and markets, both foreign and domestic, should coordinate regulatory activities and exchange information with each other. However, we believe that legislation is not necessary in this area. Both the CFTC and the SEC have entered into or are negotiating memoranda of understanding with their counterparts in the major financial centers of the world.

The CME has had extensive experience in coordinating with overseas exchanges. In 1984, the CME and the Singapore International Monetary Exchange (SIMEX) entered into a mutual offset arrangement in which a trade executed on one exchange could be offset by a transaction on the other. More recently, in connection with CME applications to trade futures contracts based on Japanese, British and world stock indexes, the CME entered into agreements to share surveillance information with the Tokyo Stock Exchange and The Securities Association in London.

In September, 1988, the CFTC, the CME and other U.S. futures exchanges agreed with three United Kingdom regulators to exchange financial information respecting companies with branches in the other jurisdiction.

The CME recognizes that the financial markets are becoming increasingly international in scope. Trading can be done in London or Tokyo as easily as in Chicago or New York. In the last five years, new futures exchanges have opened or been announced in London, Paris, Hong Kong, Sydney, Toronto, Singapore, New Zealand, Brazil, Osaka, Zurich, Tokyo, Dublin, Frankfurt. Every financial center knows the value of integrating actual or possible movement of London's FTSE 100 and Tokyo's NIKKEI indices as harbingers of the day's S&P 500 movement.

Indeed, in response to the demands of the globalization of markets, two years ago the CME entered into a long-range agreement with Reuters Limited to create GLOBEX, an automated, "after-hours," transaction system for futures and options. The GLOBEX system will provide access to the CME's markets by overseas investors during their regular business hours while the CME's trading floor is closed.

However, GLOBEX is much more than an after-hours transaction system for CME markets. The CME also is cooperating with other futures exchanges, both domestic and foreign, in connection with the establishment of GLOBEX as a shared international communications network and order matching system. In that manner, GLOBEX can be used by members of every participating exchange to trade its futures and options contracts during the hours that the exchange's trading floor is closed. GLOBEX will allow transactions in futures, options, and selected foreign financial instruments to be executed from anywhere in the world, instantly, and with financial integrity.

As of the date of this testimony, the following exchanges have agreed in principle to participate in the GLOBEX system: the New York Mercantile Exchange, the Sydney Futures Exchange, and the Marche a Terme International de France. In addition, we are actively negotiating with a number of other exchanges (both in the U.S. and overseas) regarding their possible participation in GLOBEX.

In order for the GLOBEX system to work effectively, GLOBEX order entry terminals must be placed in the major financial centers of the world such as London, Paris, Geneva, Tokyo and Hong Kong. The CME is examining the laws of those jurisdictions to determine whether any legal or regulatory problems exist which might prevent the introduction of GLOBEX terminals into their territory. One potential concern that we have is that the government of one or more of those countries may block the installation of GLOBEX terminals in its territory, not for legitimate regulatory reasons, but in order to protect the local exchanges in such country from competition. If we determine that GLOBEX is being kept out of a country for protectionist reasons, we will promptly notify the U.S. Trade Representative of the situation and seek assistance in overcoming any obstacles that may prevent us from offering GLOBEX services internationally.

Senator DODD. Thank you very much.

I appreciate your willingness to summarize this extremely worthwhile testimony, particularly the last point you made. You all went back in a very clear way, and it is very interesting to look at the testimony in terms of the actions that were taken by all three of your SRO's. I appreciate the compliments generated to Chairman Riegle as well, and how he responded in a timely way, to allow the market to have a bit of time to look at these issues. In the cool of the day, you can obviously see things a bit more clearly sometimes.

Let me ask you sort of a generic question, all three of you, and see if I can get a response. As I pointed out in my opening statement, I think yesterday the high was 2462. I do not know what is happening this morning, but we are getting awfully close to that 2500 mark that we saw on October 13, 1987.

Obviously we are talking about some legislative reforms that need to be made, and obviously the ones you have taken privately are very good ones that you deserve commendation for. To begin with you, John, if I asked you just a basic question: Are things okay today in your view, as you look at these markets?

If I asked you that question, "Are they basically all right?", what would you answer? If we were asked that by our constituents, what would your response be?

Mr. PHELAN. They are different than in 1987. The market has been pushing up with heavy volume for quite a while. There was an enormous amount of nervousness in the country about it. They talked about a 1929. I think today that we see at least in our market that there are not the same conditions, for example, the new issue market is very quiet.

While the market has been strong, it has been strong very slowly over a period of time. Volume has been very slow. And indeed, during this time of market rise, the street has been undergoing a severe internal correction. The kinds of money made in the whole equity business have dried up.

We are somewhat worried that the drought may continue longer, and that some of the capacity that is in the system may have gone overboard because of that. So it is a different kind of market today.

I do not see that anywhere, either in our markets or the options market or the futures market. The volume is down considerably in our market, and program trading is a reasonable percentage of our volume, around 10 percent. I do not see any excessive dealer participation in the market. There seems to be a good mix between individuals, institutions, and the professionals who work in the marketplace, with nobody really dominating it.

So I think there is a significant difference between now and 1987. That does not mean we could not have a sharp drop. There are concerns about what happens in the Japanese market which are very high.

Also today, what has happened is that corporate earnings have risen significantly. 1988 was an exceptional year for corporate earnings; 1989, less than 1988, but still it is a good year. So the price-earnings ratio of most securities is significantly below which it was in 1987.

Indeed, I think the Wall Street Journal, I believe yesterday, in the world-wide chart on price-earnings ratios in different markets, said that out of ten different markets, the United States was seventh, somewhere just under twelve times earnings. The Japanese market was over 60 times earnings.

So there does not seem to be the kind of speculation in our markets and other markets that was taking place in 1987.

Senator **Dodd**. Mr. Hardiman?

Mr. **Hardiman**. I would agree with what John said. The key point for us is that fundamental values in our market and in other equity markets appear to be much more reasonable today than they were in August, September and October of 1987.

In August of 1987 the P/E ratio of the S&P 500 was something like 22. Today, it is closer to 12½. The ratios for the smaller stocks are down in the 14 level, notwithstanding the strong performance of our market.

Indeed, taking a look at the NASDAQ market since the turnaround began on December 11, 1987, prices are up about 45 percent in that marketplace. Earnings of our companies have grown proportionately. People are back to fundamental investing. I think it is true of institutions as well as individuals, which accounts somewhat for the decline in volume. Volume in the NASDAQ market in 1988, and thus far in 1989, is the second-highest in any recent year in history in our marketplace, exceeded only by 1987. The volume in 1988-89 far exceeds 1986, 1985, 1984.

While we have seen a decline in volume, we have seen it from a very high period in 1987.

Senator **Dodd**. I wish you could point to another year, other than 1987.

Mr. **Hardiman**. It was an unusual year in a lot of ways. Excessive volume was a factor then. But I think investors are back to fundamental investing. They are investing for the long term, and the values are stronger.

Senator **Dodd**. Mr. Melamed?

Mr. **Melamed**. I would certainly agree with the responses by Mr. Phelan and Mr. Hardiman to the question. It is very, very hard to predict these things. I have crossed my feet and hands, like Mr. Phelan, in response. The only thing that we can predict is that the market will fluctuate. It is going to go up, and it is going to go down.

But the conditions are different, certainly in our market. The volume is down 50 percent. There is a caution that exists still in the marketplace that is felt, and it is probably a healthy caution. We just do not see the same kind of conditions that prevailed in October of 1987.

Senator **Dodd**. Two of you crossed your legs and your fingers and knocked on wood. At least I presume, Mr. Hardiman, you probably include yourself?

Mr. **Hardiman**. My legs are crossed.

Senator **Dodd**. I can see them right down here.

Aside from the obvious fluctuations which occur in just normal market activity, are there any weaknesses in the current market structures that should cause one to be concerned about the kind of crisis we were seeing in 1987, that you think need to be addressed?

Mr. **Melamed**. As a result of 1987, we have strengthened the marketplace beyond anything that was done for decades before. In less than 2 years, clearly in response to what was a highly dangerous situation, the private sector has acted very, very responsibly and put into place literally every sensible action that we could institute without disrupting or injuring the marketplace.

So I would say that we are in a much stronger position than we were in 1987, from both structural and coordinated points of view.

Senator Dodd. I agree with that totally, but do you see any weaknesses that remain? As I said, I fully appreciate what you have done. I wonder if there are any weaknesses that you see in the present structure.

Mr. Melamed. I would have to address the weaknesses in terms of the international arena. There must be more coordination internationally. International regulators should understand what the rules are, and that the rules should promulgate an equal playing field.

To some degree, there is always a danger that someone is going to try, in some regulatory way, to take our market away from us. I would suggest that we be alert to those kinds of dangers.

Senator Dodd. Mr. Hardiman?

Mr. Hardiman. I would agree that the infrastructure is much stronger today. The only areas I see that raise a level of concern are the ones that John alluded to earlier; and that is perhaps some of the international markets, in terms of relative value, may be disproportionate to what we are seeing here in the United States.

If those markets—and the Tokyo Stock Exchange is clearly the largest securities exchange in the world today by any standard—if they were to experience problems, then I would be concerned that that could have an impact upon our markets as well.

With increasing globalization of securities transactions, in not only U.S. securities but overseas securities, and the difference that exists among the clearance and settlement processes in these various countries, I would be somewhat concerned that if we were to have serious weaknesses in the international markets, the risks to the participants, including the U.S. participants in those markets, could be substantial.

Last, I am somewhat concerned that, if volume continues to be relatively light compared to the highs of 1987, we may see more leverage coming into the system, and that the levels of margins required, not only on equities but also on derivatives, could be reduced to the point where they would become troublesome again.

Senator Dodd. I might point out, by the way, that on June 14th and 15th the subcommittee will be having hearings on the internationalization of the securities markets. Federal Reserve Chairman Greenspan and others will be testifying about that. So I will alert you to that. You may want to have people here.

John?

Mr. Phelan. I think that one of our major concerns, and one of the things that we have learned about October of 1987, is that when everybody talks about 24-hour global trading, at least up until this point in time, it has been more a flow of funds from one market to another than it has been continuous product trading.

I think one of the reasons that we put so much emphasis on systems and capacity, and still do, is that both down and up you can never tell when this enormous flow of funds is going to shift from one country to another.

I think one of the interesting things about 1987 was, we knew nationally, the traders knew, when you want to liquidate you sell what you can sell and forget about whether it has value or not. That clearly happened on an international basis at that time.

So I think we are concerned about flow of funds from one market center to another around the world. Still, domestically, we have a small concern in the expirations of options. The options exchanges, particularly the two large ones, have not yet shifted the expiration date to the opening.

I think that on April 21st, we got a rather unusual expiration on a Friday afternoon. The reason you want to shift to the opening is really for public good.

We talked about the individual investor. Here, we are talking about the institution. At the opening, you can advertise and dispense throughout the world. But those imbalances at 3:30 to quarter of 4:00—it is almost impossible to do that. Therefore, the public does not have a chance to interact. And indeed, most of the institutions do not have a chance to interact. That is one of the things I think we need to continue to work on as well.

I think I also mentioned before, as Joe just mentioned, the drought, basically the effects on the whole equity system, of lack of new issues, lack of volume, small compensation within the system, and a concern again about capacity.

As I say, we are encouraging everybody to continue increasing capacity, because at least it is our view, looking now to the intermediate term, that the whole equity market, both domestically and internationally, should continue to expand. And you are going to need all the kinds of capacity to serve both the individual and the investing public, domestically and internationally. I think that is still an issue.

Mr. **Melamed**. Mr. Chairman, allow me to hasten to endorse the concept of getting the options market in line with the triple-witching expiration which already exists between the New York Stock Exchange and the Chicago Mercantile Exchange; an agreement that the CME and the NYSE instituted several years ago that has worked extremely well. What has not yet worked is that it is not synchronized with the rest of the markets.

Senator **Dodd**. When I come back, I want to get your views on the specifics on the legislation, and have some interchange with you here. You each have different points of view on various parts of this bill.

I think it would be helpful to us as a committee for each of you to discuss this with each other, in a sense, about your concerns on support or lack of support for one or the other of these.

But in the meantime, let me turn to the Chairman of the full committee, Senator Riegle.

Chairman **Riegle**. Thank you, Chairman Dodd.

I am going to pose two questions in this round. I am going to indicate what the second question is, so you can be thinking about it. That is, I want to talk to you about the problem of frontrunning, and the fact that we are going to get testimony later this morning from Mr. Jeffrey Lane to the effect of his view that clearer standards on frontrunning are needed.

I am going to ask you all what is going on, and what steps you have taken to deal with that potential for that problem in your own respective markets, particularly Mr. Phelan and Mr. Melamed. It is a relevant question, given the nature of those markets.

Let me start with the other question, which is a broader, more difficult question, but I think it is a very important one. I think there is the brain power in the room today to start to close in on this issue.

If you look at the pace of takeovers and buy-outs, it really has surged to an enormous volume. Last year and this year, far beyond past experience, tender-offer premiums paid to shareholders have risen by twelve. It is not unusual for purchasers to offer prices that are 50 percent above recent trading levels.

As I have watched that happen, I have tried to make sense out of it in terms of why, on a given day, posted market value is down at this level, and all of a sudden a company goes into play and shoots way up. And you see that pattern repeated over and over again, raising a host of questions.

One of the questions is: Is the stock being properly valued in the first instance? If not, why not? What is there in the mechanism of the markets of how the markets are working, the forces that are creating that kind of pronounced new pattern, that really is a deviation from what we have seen in the past?

I want to put a second point beside that. I am not suggesting that these are one-to-one related, but I think there is a cross connection here. I want to have you reflect aloud on what it means, if you will.

We read stories about Michael Milken earning $550 million in fees in a given year a couple of years ago. He has been charged by the SEC. At this reading, he has not been proven guilty of anything; time will tell whether that is the case. But I have to tell you, as somebody on this committee and just a citizen of the country, I have to ask myself the question: What is going on in the market system that can allow a single, in a sense, trading player to extract that kind of value out of the system?

I am wondering, what creates the value in the first instance? It seems to me, what we are talking about are companies over time that are built, assets and products established, merchandising relationships, as the inherent earned and built value and value-added of the company that is created over a length of time.

Then, we see transactional activity that suddenly takes place in which any single player—I mentioned him, but there are any number of others that might be mentioned—can come in, and through transactional activity can extract an amount of value out of the situation in those amounts. It obviously is a number of transactions that add to those totals.

It really takes my breath away. I have to tell you, I think it does with the public as a whole. And I think it leads to the presumption that, if that is going on, not just for that individual but presumably other individuals as well, what is there in the inherent way that the market is working that either so under-values assets in the first instance, or creates a kind of circumstance along the line that develops where a person who is involved in financial transactional activity can come in and capture that amount of dollar value and walk off with it?

Is that sound? Is that fair?

The other part of the question to me is: Whose value was it, before it became his value, or a person who is in that kind of a transactional situation? When I look at that, I say to myself, "Can it be that the markets are working properly, if you see those kinds of patterns suddenly develop and manifest themselves and continue to go on?"

Obviously, the SEC has taken an action in this case; but leave him aside. I use him as an illustration, because he is sort of "Exhibit A" here. But what is going on in the system that is causing this kind of a situation?

As people who are responsible for major markets, equity-type markets, what do we have to do, or what is creating that kind of a situation, where transactional activity by itself can allow people to come in and extract those enormous kinds of fees, taking that value in a sense that is there and taking it off, just by virtue of the financial transaction?

I would think that that has to be troubling to you. Maybe it is not; but it is troubling to me. I would just like to have your thoughts on what is going on here, and how we make some sense out of this, in terms of how our market systems work.

Mr. Phelan?

Mr. PHELAN. I am not sure I can make any sense out of it. But I can tell you that somebody who makes $500 million a year makes me feel a bit foolish and stupid. I spent 34 years in the business, and I would like one percent of that.

Although I did meet a Japanese gentleman, who is very modest, and ran a corporation. He personally was worth $42 billion. I assumed his income was somewhere between 2 and 3 billion dollars a year. So there are some people out there that have extraordinary income.

I think that what happened is that we are getting what I might call "intellectual proprietary products." Early on, someone like Milken found out that, indeed, there was less risk than was perceived in high-risk bonds. Aside from hostile take-overs and others, he found a lot of clients who could be financed through this vehicle, and that the fees to do that, because there was nobody else in the business—indeed, they had created at least short-term a monopoly on that—increased from 19 to 80 billion in 1987, in exponential fashion—an incredible amount of money not only for him but for the firm as well.

I think you see in that product more and more people getting into it, more and more people getting active. I think in the long term, the fees will come down and adjust themselves. Also, the monies made in the trading of those types of vehicles, commonly called "junk bonds," will lessen as more competition comes into that field.

On the takeovers themselves, I rather suspect that the corporate assets have been under-valued, because of the severe inflation of the 1970's, and that originally financial engineers were smart enough to understand that the parts were more valuable than the whole.

The markets themselves have traditionally, and still do, price earnings and cash flow. They do not price assets on liquidation. The difference between earnings and cash flow, and assets upon liquidation, is that there has been a lot of spread in the market—it may be lessening somewhat now, because many, many institutions are going into it. You can raise incredible amounts of money today, so the competition will probably eventually bring a more efficient pricing mechanism to the ultimate bidder for those products.

The fact that you could at one time buy a company for one-and-a-half times the value of it, and 6 months later sell it for five or six times that value, I think is beginning to diminish, as more people are studying not only the whole but the parts. And more money is going to enter into those things as well.

I think that what has happened is that all of those assets were extremely under-valued, and that hopefully, over a period of time, the markets themselves and competition will correct that.

I think the solution is to get more competition into those markets, because I feel that more money can be put in there as well. I have thought long and hard about what rules and regulations or legislation would solve the problem. It just seems, over a period of time, that the cure is sometimes worse than the problem itself.

So I really cannot offer any good solutions today, other than that it seems that competition and new money are slowly correcting it over a period of time. But you certainly do get extraordinary compensation by firms and by individuals while that correction is going on.

I think it is something that makes us all very uneasy, and certainly gives us pause for thought. Whether the whole system should be changed to correct that is something else.

Chairman RIEGLE. I want to just say one thing, and then I want to ask Mr. Melamed for his comment on that as well. That is, there are a lot of collateral effects. One of the collateral effects is, we are seeing a general shift in the composition of balance sheets away from equity and toward debt.

You are principally equity markets, rather than debt markets, although there is a mix. But I am very much concerned about a whole host of collateral effects. It still leaves the question: Why is it that markets, if they are operating properly, so under-value assets? Because we need to accept the thesis that they are sort of using the old system on valuing profits and cash flow, rather than current value or what-have-you, so that is what justifies these sudden runs up in prices almost overnight. In two or three days, you get these huge adjustments.

I think, as people responsible for how the markets work, you cannot make the markets do what anybody might want, including yourselves. But I think it still leaves the question as to why the valuation process is functioning in that fashion. And is there something in the mechanism of the market, is there something in all of the ways and the cross-connects in terms of the ways that value is established, trading volumes are taking place? Is it in the market, out of the market? It is encouraged to come in? It is driven out?

I mean, look at the problem of combines, and the legal activity, insider manipulation and trading. There has been plenty of that. That has been a part of this problem. But it seems to me that, even as that gets ferreted out and prosecuted, we are still left with a pattern here that I still think we do not have all the answers to. I, for one, am concerned about it.

It seems to me that maybe we have not pushed ourselves hard enough yet to understand fully what is going on here.

Mr. Melamed, let me have your thoughts, please.

Mr. **Melamed**. Thank you, Mr. Chairman.

I am afraid that you have asked a very deep philosophical question, and you are not going to get any wiser by my answer. Your question concerns an area quite different from my expertise in futures. As you know, futures represent the market as a whole, and not any of its parts. Your question pertains to one part of the general market.

Actually, your own assessment touches the correct button for the answer. The money in the LBO process comes from the enormous debt created. Somehow, the market is paying out in front for something that either will work out in the years to come, or will never work out. That is of course, the critical issue. If it doesn't work out, who will pay and what will be the ramifications, clearly, the ramifications will be complex and serious. I cannot, however, suggest any legislation to answer or protect these potential problems. The market will re-evaluate the quality of this debt and price it accordingly.

As to whether one individual deserves to earn the kind of money your question suggests is a query I would hesitate to answer. Certainly, it brings into mind concerns many of us have with insider trading questions and legislation to make the market fair for everyone.

If time permits, I would be glad to respond to the second question you posed, with respect to frontrunning.

Chairman **Riegle**. I do not want to trespass too much on my time.

Mr. **Hardiman**. Could I just add one thought?

Senator **Dodd**. We will have to divide up our time a little bit here. We do not want to keep you too long, but go ahead.

Mr. **Hardiman**. I would add, it is a complex problem; but there is one thing that should be taken into account, in that a lot of this debt, high-risk debt, looks like and smells like equity, and I think it is booked in that form, because of the tax advantage. I think that is a factor.

I think it encourages people to use debt that otherwise would be considered to be equity, in terms of making these transactions and completing them in a very profitable way. I do not think you can escape the tax consequences, even though that may be a very delicate subject in today's world.

Chairman **Riegle**. You wanted to make a comment, Mr. Melamed.

Mr. **Melamed**. Only to the effect that I am fairly satisfied on the definition agreed to by the New York Stock Exchange and the Chicago Mercantile Exchange, in terms of intermarket frontrunning. The definition has been approved by the CFTC, it is awaiting approval by the SEC, and will be implemented subsequent to that.

Chairman **Riegle**. So is that to say, then, that you do not feel there is a problem there? Or, you think that action is in the works to solve the problem?

Mr. **Melamed**. I do agree.

Chairman **Riegle**. To which? The first, or the second?

Mr. **Melamed**. I agree that there should be no further problem in terms of the understanding of the common definition of frontrunning, the implementation of which is also agreed to after it has been approved by the regulatory bodies.

Chairman **Riegle**. I would like to have each of you give for the record, Mr. Melamed and Mr. Phelan, a listing of the steps that have been taken already, apart from the agreements worked out but not yet fully implemented. I would like to know what steps have been taken to restrict frontrunning, and to deal with the problem of insider abuse or market manipulation.

I would like you to give me that, if you would, for the record.

[The information follows:]

CHICAGO MERCANTILE EXCHANGE

Alysann Posner
Vice President-Special Projects
312/930-8548

June 12, 1989

VIA FACSIMILE

Mr. Edward M. Malan
Senate Committee on Banking,
Housing and Urban Affairs
Room SD 534
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Ed:

On Friday, June 9, we sent to you the edited transcript of Mr. Melamed's testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Securities on May 18, 1989. I trust that you have received this document. Again, I thank you for allowing an extension of time for the editing of this document.

As I stated in that letter, the CME's response to Senator Riegle's question (p. 68 of the testimony transcript) with respect to front-running (trading ahead of a customer order), insider trading abuse (misuse of confidential information) and market manipulations would be sent under separate cover. Attached is our response.

If you have any questions regarding the attached, please do not hesitate to call me.

Very truly yours,

ALYSANN POSNER

AP:jas
Enclosure

cc: Michael Stein

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CHICAGO MERCANTILE EXCHANGE

CHICAGO MERCANTILE EXCHANGE
RESPONSE TO SENATOR RIEGLE

Front-running (trading ahead of a customer order), insider abuse (misuse of confidential information) and market manipulations are violative of Chicago Mercantile Exchange (CME) rules. (See Exhibit A for CME rules prohibiting front-running, Exhibit B for rules prohibiting misuse of confidential information and Exhibit C for rules preventing market manipulations.)

The following is a brief description of the CME's in-house systems and the steps taken by the Exchange to coordinate its activities with security exchanges in these areas.

A. FRONT-RUNNING

CME rules and Commodity Futures Trading Commission (CFTC) regulations prohibit trading ahead of customer orders regardless of whether the trade is made on the floor of the CME or on another exchange. Customer harm need not be proved.

The CME has also worked closely with the New York Stock Exchange (NYSE) to develop a joint interpretation with respect to inter-market front-running. The CFTC has approved the CME's version, and the NYSE is awaiting approval by the Securities and Exchange Commission (SEC). As soon as the SEC acts favorably, the CME will begin daily computer-to-computer transmission to the NYSE of surveillance information respecting trades executed on our Exchange. The NYSE will, in turn, transmit to us its Daily Program Trading Reports. We are confidant of the ability of our Market Surveillance staff to review this data for inter-market front-running activity.

The CME uses two programs to detect intra-market front-running. First, our automated compliance system compares all customer orders executed each day by a member to all trades executed by that member for his or her personal account. Second, our automated compliance programs also search for the possibility that a member executed a trade for the account of a confederate ahead of the customer order. Again, all trades are reviewed each day.

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A third program, expected to be functional within four to six months, will identify large orders and highlight accounts that purchased prior to the execution of large buy orders or sold prior to the execution of large sell orders. This will indicate potential situations where a customer order was disclosed to another who took advantage of it. This information will be provided to the NYSE, as necessary.

The CME has fully cooperated with all efforts to detect inter-market front-running. Since 1985, the CME has, through its participation with the Intermarket Surveillance Group (ISG), furnished security exchanges with market data for their review with respect to inter-market front-running. In turn, the CME has received data from securities exchanges for similar review.

This information has also been exchanged for purposes of reviewing for market manipulations. Even prior to exchanging data for these reviews, however, the CME and the security exchanges, beginning in late 1983, exchanged information relative to large positions of market participants during the week of the expiration of our equity index contracts. This information was exchanged primarily to review contract expirations (Triple Witching Hour Matters) in conjunction with the NYSE and Chicago Board Options Exchange.

Since early 1986, the CME has routinely participated in ISG meetings even though our Exchange is not an official member of that group. We are currently negotiating with the ISG to become an affiliate member. Our status with respect to that group, however, in no way affects our willingness to exchange information.

B. MISUSE OF CONFIDENTIAL INFORMATION
(Insider Trading Abuse)

CME rules and CFTC regulations prohibit the misuse of confidential information by Exchange members and staff.

The first step in protecting against the misuse of confidential information is to limit access. CME members do not have access to confidential information except in the event of an emergency. In such an emergency situation, members of the Business Conduct Committee or the Board of Governors will be provided with enough information to make an informed decision. Committee members with a conflict of interest are excused from the proceeding.

The CME's Market Surveillance staff review positions held by Committee members and their affiliated firms to determine whether any conflict exists prior to the disclosure of the confidential information. Additionally, the nature of the information disclosed is included in Committee minutes, which are subject to CFTC scrutiny. In the event that information is disclosed to the Committee, CME policy is to review trading of Committee members afterward to ascertain if the information was used. As a deterrent, Committee members are informed of this routine review at the beginning of the meeting.

Although a limited number of staff has access to confidential information, no CME staff may trade futures or options on futures at any domestic or foreign futures exchange.

The above prohibitions apply to position information that is maintained at the CME for all members and their customers. Each member firm maintains customer position information, but is prohibited from misusing this information.

Members are also prohibited from disclosing another person's order, except to an employee of the CME or to the CFTC. Thus, if a member were to disclose an order to another member, thereby allowing the other member to trade ahead of the customer order, both members would have violated Exchange rules.

As indicated in Section A above, the CME has furnished the NYSE with information for its use in investigations respecting front-running and misuse of confidential information, and will continue to furnish the NYSE with such information, as needed.

The NYSE has never asked the CME to provide any information to them with respect to insider trading regarding a particular stock. While we agree with them that our information would not be useful, we would nevertheless assist them in any manner possible respecting insider trading or any other investigation.

C. MARKET MANIPULATIONS

The Commodity Exchange Act authorizes and directs the CFTC to designate a board of trade as a contract market if that board of trade provides, among other things, for the prevention of manipulation of prices. To effectuate this, the CME employs a staff of eighteen in its Market Surveillance Department to monitor Exchange markets in order to prevent manipulations.

One major tool in preventing manipulation is the CME's large trader reporting system. Each CME member firm is required to notify the Exchange on a daily basis whenever a market participant has positions in any one contract month that exceed the reportable level.

The reportable levels are as follows:

1. Agricultural Markets - 25 contracts
2. Currency Markets - 200 contracts
3. Interest Rate Markets - 100 contracts
4. S&P 500 Market - 100 contracts

These reporting levels provide the Exchange with information detailing the number of positions held and by whom. Because the reporting levels are low (in fact, they are the lowest in the industry), the CME's Market Surveillance Department has significant knowledge of the composition of its markets. In addition to the number of positions held, the notification form requires the market participant to list any other firms carrying its accounts and other accounts in which the market participant has an interest.

It is estimated that as a result of the CME's large trader reporting system, the Exchange knows 65%-75% of the composition of its agricultural markets, 70%-80% of its currency markets, and 80%-90% of its interest rate and S&P 500 markets. This has allowed us to monitor market situations closely and to contact customers directly when necessary.

As indicated above, the CME has furnished the securities and option exchanges, on a quarterly basis during the expiration of our index products, information detailing the number of positions held in S&P market and by whom. This information is combined with information at securities and option exchanges to ascertain the combined effects of the positions that market participants are carrying at the exchanges. This information is used to detect market manipulations.

In situations where the CME needs to act to prevent manipulations, it may take any action necessary, including:

1. Termination of trading;
2. Limiting trading to liquidation of positions only;
3. Ordering liquidation of all or a portion of a member's or customer's positions;
4. Fixing a price at which all contracts will be liquidated;
5. Confining trading to a specific price range; and
6. Modifying the trading days or hours.

Direct phone connections among the participating exchanges' operations areas and board rooms was established in December 1988. This was instituted to coordinate any actions, including emergency actions, between participating exchanges.

By bypassing conventional telephone hook-up, expeditious communications among the exchanges is assured.

D. CONCLUSION

The CME is committed to furnishing the NYSE and any other security or futures exchange with information necessary to detect violations of our rules or their rules, including the detection of front-running, misuse of confidential information, and market manipulations. Our past actions, e.g., sharing market intelligence; coordinating a "triple-witching" resolution; and adopting coordinated price limits with the NYSE, demonstrate our commitment to assuring the orderly trading of our markets, to detecting and prosecuting rule violators, and to assisting other exchanges in their enforcement responsibilities.

This brief description of our systems and our efforts does not do justice to the efforts of our Exchange. We extend to you and your staff an invitation to visit the CME to view our systems and to discuss these matters with our staff who are working with the other exchanges.

EXHIBIT A
Page 1 of 3

RULES PROHIBITING FRONT-RUNNING AND UNDER WHICH MEMBERS MAY BE PROSECUTED

1. INTRA-MARKET.

A. 432. **MAJOR OFFENSES.**—It shall be a major offense:

* * * * *

b. to be guilty of fraud or any act of bad faith;
c. to be guilty of any dishonest conduct;

o. for a member or clearing member to permit the use of its facilities or membership privileges by a member or nonmember in a manner that impairs the dignity or degrades the good name of the Exchange, or creates a market or other situation detrimental to the Exchange, or results in violation of the speculative limit rules, or effectuates manipulations or corners or attempts at either; or to itself do any of the foregoing;

q. to commit an act which is substantially detrimental to the interest or welfare of the Exchange;

* * * * *

B. 530. **PRIORITY OF CUSTOMERS' ORDERS.**—A member shall not buy a futures contract, buy a call option or sell a put option for his own account or for an account in which he has a proprietary interest, when he has in hand orders to buy a futures contract, buy a call option or sell a put option for others at the market or at the same price.

A member shall not sell a futures contract, sell a call option or buy a put option for his own account or for an account in which he has a proprietary interest, when he has in hand orders to sell a futures contract, sell a call option or buy a put option for others at the market or at the same price.

A member shall not knowingly execute a discretionary order, including, without limitation, an order allowing the broker discretion as to time and price, for an immediate family member, another member or a proprietary account of a member firm, when he has in hand customer market orders open as to time and price. A floor broker may trade for his own account, without violating this rule, while holding customer orders open as to time and price provided the customer has previously consented in writing and evidence of such general consent is indicated on the order. (See "DRT" in Definition of Orders.) Violation of this rule shall constitute a major offense.

EXHIBIT A
Page 2 of 3

2. INTER-MARKET.

A. 432. **MAJOR OFFENSES.**—It shall be a major offense:

* * * * *

b. to be guilty of fraud or any act of bad faith;

c. to be guilty of any dishonest conduct;

o. for a member or clearing member to permit the use of its facilities or membership privileges by a member or nonmember in a manner that impairs the dignity or degrades the good name of the Exchange, or creates a market or other situation detrimental to the Exchange, or results in violation of the speculative limit rules, or effectuates manipulations or corners or attempts at either; or to itself do any of the foregoing;

q. to commit an act which is substantially detrimental to the interest or welfare of the Exchange;

* * * * *

B. Rule Interpretation Regarding Inter-market Frontrunning.

CHICAGO MERCANTILE EXCHANGE/NEW YORK STOCK EXCHANGE
INTERMARKET TRADING RESTRICTIONS

The Chicago Mercantile Exchange, in conjunction with the New York Stock Exchange, has adopted the policy set forth below.

If a member or person associated with a member or member organization executes or causes to be executed, for an account in which such member or person has a direct or indirect pecuniary interest or for an account with respect to which such member or person exercises investment discretion, any transactions described below to take advantage of material, non-public information which can reasonably be expected to have an immediate, favorable impact in relation to such transactions, such member or person may be in violation of Exchange Rules 432.b., 432.c., 432.o., and 432.q.:

EXHIBIT A
Page 3 of 3

i. a transaction in any stock index futures contract, or option on a stock index future when such member or person has acquired knowledge of the imminent execution of another person's stock program transaction;

ii. stock program transactions, when such member or person has acquired knowledge of the imminent execution of another person's order(s) in stock index futures contracts or options on stock index futures.

In determining whether a member or person has taken advantage of material, non-public information, it is not necessary for the Exchange to demonstrate that another person has been disadvantaged. Further, such member or person may be in violation of just and equitable principles of trade regardless of whether the other person has given permission for such trading.

However, nothing herein shall prevent such member or person from establishing, in a futures market, a bona fide hedge of risk such member or person may have assumed or agreed to assume in facilitating the execution of any other person's stock program orders.

In addition, nothing herein shall prevent a member or person associated with a member organization from implementing a proprietary market strategy involving a stock program and a related stock index futures transaction by executing the stock index futures trade(s) prior to the execution of the stock program. However, if the member or person executes or causes to be executed a transaction in one market to take advantage of such member's or person's imminent transaction in a related market, that member or person may be engaging in manipulative activity.

EXHIBIT B
Page 1 of 2

RULES PROHIBITING MISUSE OF CONFIDENTIAL INFORMATION AND UNDER WHICH MEMBERS MAY BE PROSECTUED OR STAFF MAY BE TERMINATED

1. APPLICABLE TO MEMBERS.

A. 233. **CONFLICT OF INTEREST—DISQUALIFICATION.**—Whenever the Board considers a matter in which a Board member is likely to have a significant and direct financial interest, the Board shall take all necessary steps to ensure that no participating Board member has a conflict of interest. A Board member shall be excused from the meeting during the Board's consideration of such matter if:

1. He directly or indirectly owns or controls an account that is likely to be directly and materially affected by the Board's decision;
2. He has substantial financial interest in a clearing member that may be directly and materially affected by the Board's decision; or
3. He has an interest in the outcome, which a majority of the Board, present and voting, deems to require his disqualification.

If there is no Board quorum, then the Executive Committee shall assume all of the powers and duties of the Board with respect to the action; if there is no Executive Committee quorum, the Chairman, or if the Chairman is disqualified, the next highest ranking officer, shall appoint an ad hoc committee of six eligible members to act for the Board in this matter.

B. 402. BUSINESS CONDUCT COMMITTEE.—

* * * * *

No person shall serve on the Business Conduct Committee unless and until he has first pledged to the Exchange that during the period of such service he will not publish, divulge, or make known in any manner, any facts or information regarding the business of any person or any other information which may come to his attention in his official capacity as a member of the Business Conduct Committee, except when reporting to the Board or to a committee concerned with such information or when called upon to testify in any judicial or administrative proceeding. Violation of the pledge shall be a major offense.

* * * * *

(Note: Similar rules exist prohibiting disclosure of confidential information by members of all other committees that may have access to confidential information)

EXHIBIT B
Page 2 of 2

C. 432. **MAJOR OFFENSES.**—It shall be a major offense:

* * * * *

m. to make improper use of or reveal any confidential information obtained by reason of participating in any Board of Governors or committee meeting or hearing;

* * * * *

D. 532. **DISCLOSING ORDERS PROHIBITED.**—A member shall not disclose another person's order to buy or sell, except that he may disclose it to an officer of the contract market or of the CFTC without violating this rule. Violation of this rule shall be a major offense.

2. APPLICABLE TO STAFF.

255. **EMPLOYEE RESTRICTIONS.**—

A. No employee of the Exchange shall:

1. Trade directly or indirectly (a) any futures contracts or commodity options on any U.S. designated contract market or on any foreign market or (b) any securities option contracts which are closely related to the contracts traded on the Exchange; provided, however, that this rule shall not prohibit an employee from buying or selling shares of mutual funds or other investment vehicles which may buy or sell the foregoing types of contracts, but only so long as the employee has no control or discretion with respect to the purchase or sale of such contracts. An exemption to permit an employee to trade securities option contracts which are closely related to the contracts traded on the Exchange may be granted by the Executive Committee on a case-by-base basis.

3. Disclose to any other person any material non-public information obtained as a result of his or her employment at the Exchange; provided, however, that this rule shall not prohibit disclosures made in the course of the employee's duties, or disclosures made to another self-regulatory organization, linked exchange, court of competent jurisdiction or a representative of any agency or department of the federal or state government acting in his or her official capacity; and

B. Employees who violate the restrictions of this rule shall be subject to immediate dismissal by the President. Members of the Exchange who cause employees of the Exchange to violate this rule or who are aware of violations of this rule and do not promptly report such violation to the President may be guilty of a major offense.

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EXHIBIT C
Page 1 of 1

RULES PROHIBITING MARKET MANIPULATION AND UNDER WHICH MEMBERS MAY BE PROSECTUED

1. 432. MAJOR OFFENSES.—It shall be a major offense:

* * * * *

h. to manipulate prices or attempt to manipulate prices or to corner or attempt to corner the market;

o. for a member or clearing member to permit the use of its facilities or membership privileges by a member or nonmember in a manner that impairs the dignity or degrades the good name of the Exchange, or creates a market or other situation detrimental to the Exchange, or results in violation of the speculative limit rules, or effectuates manipulations or corners or attempts at either; or to itself do any of the foregoing;

q. to commit an act which is substantially detrimental to the interest or welfare of the Exchange;

* * * * *

2. 543. SPECULATIVE POSITION LIMITS AND EXEMPTIONS.—

A. Bona Fide Hedging Positions

* * * * *

f. Hedges are moved in an orderly manner in accordance with sound commercial practices, and are not initiated or liquidated in a manner calculated to cause unreasonable price fluctuations or unwarranted price changes. The hedger does not use said hedges in an attempt to violate or avoid Exchange rules, or otherwise impair the good name or dignity of the Exchange.

* * * * *

Chairman Riegle. If there are things up in the air that you are working on that you hope to implement, I would like that also as an add-on. Can you do that?

Mr. Phelan. I think in the area of frontrunning, you always have a problem with definition. But in the securities and options markets, which is what it is really related to, there has been a rule for a very long time now, at least eight or ten years, on frontrunning in customers' orders for a firm's own proprietary account, when the firm knows what the customer is doing.

That really developed out of the options market, in which they felt that people who see orders coming in equity trading will jump to the front and either disadvantage the customer or create a profit for themselves that would not ordinarily take place.

There had been any number of frontrunning cases in those areas. We formed with the other exchanges the Intermarket Surveillance Group. We share data on all of those exchanges. We are constantly having requests from the options exchanges on who did what in our market, and so forth.

Chairman Riegle. Is there more needed?

Mr. Phelan. In the options and equity area? I am not sure that we perceive it to be. I think that perhaps better surveillance is needed. It is not an easy thing to know on the trading desk who sees what and when that order comes in. I think that is why an audit trail and other things are so important.

There was no agreement—and I think this is the important thing—between the equities and futures markets. There are different cultures and different definitions of frontrunning.

What we have really tried to do is not to have exactly the same definition, but to have similar definitions that at least would fit into each environment. And then, we began to exchange information and requests, and keep looking at both our surveillance systems and their surveillance systems, to see if something comes up.

I cannot tell you at this time—because we have not had a lot of experience with it—whether that is working as well as the rules and the cooperation in the equities and options areas. But we certainly are working together on that.

I think that the difficulty is in the futures area, and what we need to do is to be able to supply those exchanges with the information that we have as far as equity trading is concerned, so that there is cooperation.

We need more experience and time, to see how pervasive it is, if indeed it is pervasive. And we have got to see whether the current regulations and the current cooperation are working to solve that problem.

Senator Dodd. Thank you very much.

I am going to ask, if we can, to try and keep this process down to 6 or 7 minutes. We will try to get through as many rounds as possible.

Senator Sasser.

Senator Sasser. Thank you very much, Mr. Chairman.

Gentlemen, over a year ago, Nicholas Brady, now the distinguished Secretary of the Treasury, testified before this committee on the occasion of delivering the report of the Brady Commission on the stock market crash.

Secretary Brady said, and I quote, "We are looking down the barrel of a gun, and it's loaded."

Now, what Secretary Brady meant at that time, as I interpret it, is that we could get into another situation of the same or similar nature as we did in October 1987. Do you think that we presently have safeguards in place that would unload that gun Nick Brady is talking about? Or, is it possible to put such safeguards in place?

Do you want to take a shot at that, Mr. Phelan?

Mr. PHELAN. We have certainly worked very hard to try, first, to understand the experience of 1987, and second, to understand its intermarket as well as international implications.

I think that by doing a number of things that we have done, such as the circuit breakers, reinforcing the rules and regulations on each of our markets, cooperation toward similar rules and regulations and so forth, that certainly the system is stronger today than it was then.

The problem is that, the next time you have a problem, it is always slightly different from the last one. I think you need to keep probing. You need to keep being restless. You need to keep eternal vigilance on all those things.

So I do not know what Nick Brady had in mind when he talked about the smoking gun, but I think the Chairman asked the question before about what kind of a condition the market is in today.

It is in a different condition today. There have been more things put into the system. But I certainly could not give you an assurance that somewhere down the line we might not have another liquidity crisis at some point in time. There will be a lot more people planning to deal with the problem than there were.

Senator SASSER. Does anyone else wish to comment?

Mr. MELAMED. I would say that, to the extent that we were able to identify as a disconnect between markets, those structural remedies that could be put into place without in fact disrupting the market entirely or disbanding it have been put in place. So while there can be no guarantees in this area, I think the markets have done everything that they could in terms of the lessons of 1987.

Senator SASSER. In the aftermath of "Black Monday", the specialists on the New York Stock Exchange were subject to some criticism. I am not sure whether that criticism was deserved or not. But there was some criticism, and some were saying that the specialists spent just about all of their time selling on that dark day, instead of buying and acting as a break on the market, as they were supposed to do.

I notice that you made a number of improvements in the specialist system, Mr. Phelan. In particular, I see you have attached a new specialist job description to your testimony. Would you care to expand on this? How is the new job description working out? Is it a safeguard that we have perhaps improved?

Mr. PHELAN. First of all, I think it certainly was not correct that the specialists were net sellers. They were in fact significant net buyers on that day. I believe that the measure used in the staff report of the Brady Commission was that in certain stocks they sold when the stock was down that day. And that has never been a criterion of specialist performance.

What happened is that we judged that by and large the inventory of the specialists on that day was far greater than it was at the beginning of the day.

Having said all that, we did think that there were 11 or 12 instances where we thought they should have used better business judgment, and we reallocated those stocks; which is, I think, a significant step for the Exchange.

Second, we increased specialist capital requirements from $100,000 to $1 million, and more importantly we required that instead of carrying 5,000 shares of each stock, that they carry 15,000, and we increased our depth guidelines from over 1,000 shares to over 3,000 shares.

I think we are in a continuing series of processes, and we have continued to increase the capital in the system and the standards by which they perform. And if they do seriously under-perform, then we will continue to reallocate stocks.

We would also encourage diversification. We would also encourage member firms to become affiliated with specialists. The most significant one at present has been the acquisition by Bear Stearns of the specialist unit that makes the market in IBM.

So I think the specialist system, as the SEC said, did a reasonably good job on that day, about as much as could be expected of them. We have in fact strengthened the market where it needed strengthening. We have in fact strengthened the entire system.

Senator SASSER. Does anyone else wish to comment on that? [No Response.]

In the testimony that Charles Schwab submitted for the record, Mr. Schwab expresses a great deal of concern about program trading, particularly the come-back that he seems to feel that program trading has been making in recent weeks.

Does our panel think that program trading increases the volatility of the markets? Does it discourage small investors from participating? If that is indeed the case, should we try to do anything about it here on this committee, in this Congress?

Mr. PHELAN. Let me just speak to that again. In program trading, I think most people refer to index arbitrage. In 1987, when an enormous number of institutions were doing portfolio insurance, the correction in the market changed the habits of many institutions on that.

After a drop in January 1988, we put a "collar" on the market, in which we took programs off the system once the market had moved to a certain level. But when we did the circuit-breakers and other agreements with the CME, we took that collar off. And since that time, for almost a year now, we have been publishing monthly statistics on program trading; first, to have an educational value, to let people understand more about what it is, how it works, and who does it; and second, we published figures on the firms that do it, both for their own accounts and for customers as well.

I think what everybody has got to understand is that the world goes forward. It does not go back. There are entirely new products in the marketplace, and the use of futures markets in order to hedge risks and do other things is something that is well established today, particularly by the pension funds of this country that represent a good many individuals, including most of us at this table.

That kind of money finds equities, futures and options to be of value. I think it is unrealistic to think that those products will disappear. What we are trying to do over a period of time is to integrate them into the market, get everybody to understand better what they are. And, if indeed customers have a problem with them, they should go and deal with the firms, their own firms, at which they have those accounts, and express their pleasure or displeasure.

At the present time, arbitrage is running about 9 or 10 percent of total volume. The markets themselves seem to have returned to a reasonable portion of professional trading by individuals and institutions. And, at least from our point of view, we do not need to see any increase in volatility or dislocations.

Indeed, from a volatility point of view, 1988 was probably the least volatile year in the market in some 20 or 25 years.

Senator **Sasser**. Does anybody else wish to comment on that?

I would comment only to say that program trading and index arbitrage are legitimate and natural market activities that have come on the scene over the last number of years. They probably will continue in one fashion or another, because they are activities that market users find valuable.

In the current climate, market users are using these strategies very prudently, and there should be no interference in the process from the legislative point of view.

Mr. **Phelan**. I will make one other comment. There are any number of products that will come along in the years to come, because the markets have been creative and inventive. I think when we deal with the individual investor, all of us have a burden and responsibility to continue to try and educate not only ourselves and the institutions, but the individuals as well.

The investor, per se, is not a daily trader in the market. He does not jump in and out. If the individual continues to do his homework, whether it be in our market, Joe's market, or anybody else's, and really stays there for the long pull and buys for what he thinks is value, then the intra-day and day-to-day fluctuations in the market really should not have any influence on the adjustment of that investment.

They have to learn that, just like the ocean, sometimes it is rough and sometimes it is smooth; but if you keep your course and know where you are going, you do get through the storms and you do get through the volatility to where you want.

I think we all have a responsibility and obligation to continue to educate all of ourselves, including the individuals, that investing is for the longer haul. It is not for the daylight trader. If you do your homework, and you pick a company in which earnings are growing and other things are growing, the day-to-day fluctuations in the market really have no bearing, or very little bearing, on the long-term objective of where that stock is going.

Senator **Sasser**. Thank you, gentlemen.

Senator **Dodd**. Thank you, Senator Sasser.

Senator Pressler.

Senator **Pressler**. Thank you very much.

This may have been covered in some of the earlier testimony. Since we are holding a hearing on S. 648, the Market Reform Act of 1989, I would like to ask a question that would fall within this framework, and get each of your three comments.

The Brady Commission concluded that there is one market concerning stock options and stock index futures. The Brady Commission recommended the Fed. be given authority to oversee it. Is that a desirable goal, whether it is the Fed. or some other authority? Does this bill show some movement in that direction, that is the Bill S. 648?

If S. 648 were enacted, it would provide the SEC with authority to gather a host of information from the markets. What responsibility will the SEC have in acting upon that information? Does the responsibility remain divided? Should we have a single authority, such as the Fed. has recommended by the Brady Commission?

That is the whole framework of the question. I guess I will just start from the left and go to the right.

Mr. **Melamed**. Senator, I believe that the experience of October 1987 has given us an understanding that the regulators can work together, and there is good reason to keep regulators separate in terms of the differences between the markets themselves.

Each regulatory agency performs a valid and important function. What is needed is the kind of coordination that is now in place between them. We have seen that coordination work. We know that it is in place, and we are satisfied that the regulatory agencies can remain the way they are in terms of the separate markets.

Senator **Pressler**. Do you read this bill as a step in that direction, though? Just the fact of the information-gathering portion of it?

Mr. **Melamed**. Large trader reporting is an attempt to equalize information between the different agencies. This would enable the SEC to gather large order information similar to that which is already obtained by the CFTC for futures markets.

Insofar as that does not force interplay between information that may be counter-productive, it certainly is an idea that draws our support. Each agency should get the kind of information that it needs.

Mr. **Hardiman**. Senator Pressler, in terms of a single authority, the NASD Board went on record last year as being opposed to a single authority at that time. In March of 1988, we responded to inquiries by Senator Proxmire. We suggested that we should give time a chance to work, to see whether the regulatory agencies and the self-regulatory organizations could work together.

In terms of the self-regulatory organizations, there is an awful lot going on in terms of cooperation, discussion, and communications, and indeed action. In terms of the regulatory agencies, the President's Executive Order brought them together, at least through the mid to late part of 1988. And I think they did function well together.

As was pointed out in some of the opening statements, they have not functioned thus far in 1989. I think that is unfortunate. If the Working Group cannot work together, in terms of coming together under the terms of the Executive Order, then perhaps legislation would be in order.

As far as information gathering is concerned, just quickly, I would say that the information that is being requested—I believe that it is generally available today in a very targeted way, in response to specific investigations that may be triggered by the SEC or by the SRO's. So we have some doubts as to whether the large amount of information, particularly in the large trader areas, that is being requested by the SEC is necessary, and indeed is cost justified.

Mr. **PHELAN**. Senator, I think early on we had supported the Brady recommendations, but I think it became fairly apparent that it is better for all the markets and better for all the constituents in the markets to get on with the cooperation between different agencies and the cooperation between different markets.

As I testified earlier, I think that cooperation has worked better than any of us would have imagined at that time. So I think the system today is working very well without a single regulator.

As far as the information sharing is concerned, it just seems to me in this modern day and age of communications that the people overseeing the market should know as much about participants in each market, both the institutions and the individuals, as possible. However, there should be some information that is kept on a confidential basis, and to which access is restricted.

I see no reason in the world why there cannot be cooperation between the SEC, the CFTC, the Fed., and the Treasury, on the sharing of that information on a need-to- know basis and when there is systemic risk to the system, or when there are pervasive regulatory problems, such as insider trading and manipulation.

So I think we support, on a narrowly defined basis, the gathering of certain information, so that you can assess it in the system. But I think you really do have to take into consideration the proprietary rights of the firms in developing the product, how they are making money, and how they are relating to their competitors as well.

Senator **PRESSLER**. You may have answered this already, and I apologize for not being familiar with it, having a mark-up to which I have to return. I presume that all three of you would urge a vote for the bill, S. 648, as written?

Mr. **MELAMED**. Actually, we each have different segments of the bill that we are uncomfortable with.

Mr. **HARDIMAN**. Senator, we oppose the provision dealing with the emergency market authority for the SEC. We support the provisions dealing with the clearance and settlement coordination. We think this is still one area that needs an awful lot of not only study but action.

Last, we are asking for a greater demonstration of need for the information that is being requested by the SEC on the risk-holding assessment of companies' provision and on large traders.

Mr. **PHELAN**. I think, as was said earlier, Senator, that we support the SEC emergency authority. Large trader reporting should be collected by the firm itself, and only called up by an SRO or regulator in a narrowly defined situation when it is needed, either for reconstructing the market as in October of 1987, or for investigating manipulation or insider trading.

There really has to be a greater understanding within the holding company whether there are any systemic risks that are in some way being created there that nobody understands.

We are certainly not advocating wholesale regulation of holding companies, but at least I think, on the part of the equity firms anyway, that the SEC should at least have some idea and some consultation with the holding companies as to what they are doing and how they are providing for the risk within the system.

I think a little more has to be done in the area of coordinated clearance and settlement. I think we need a great deal more understanding of how the clearance and settlement processes work in this country, how they are working together, and then having done that how they are going to work internationally. Because we have got a number of other major markets out there which happen to be linked together, and a number of people, including the Group of 30, who have made recommendations.

So I think study and understanding of the clearing and settlement process is needed.

Senator DODD. Mr. Hardiman, can I just jump in here for a second?

As I understand it, if we more narrowly define what we are trying to do in these areas, you might be able to be supportive. Your problem is that right now it is too broadly gauged?

Mr. HARDIMAN. It is too broadly gauged, and the demonstration of a precise need for the information that is requested in the broad language of the statute has not yet been made to us clearly. I think there is a session going on at the Commission today between representatives of the industry and the Commission staff, on those particular points.

If they can satisfy our members on those particular points, I am sure they can satisfy us.

Senator DODD. With a more narrow definition, your objections might not be as strong?

Senator PRESSLER. Then at present, all three of you are appearing in opposition to the bill?

Mr. PHELAN. Not really.

Mr. MELAMED. No. The CME could support the large trader reporting requirements, for instance. But only, if the SEC does not collect data on futures that firms already provide to the exchanges and to the CFTC.

I think I can understand Mr. Phelan's viewpoint with respect to the confidentiality. There are also differences in how the data would be used that is important to consider. We use large trader reporting in futures to evaluate financial risk. Our exchange needs that information on a daily basis to make decisions. The SEC may have different uses for the data they are requesting.

We believe that information gathering ought to occur at the SEC, but that they should acquire and use the data in a fashion that meets a comfort level for the equity markets. They may only need the data on an as-needed basis. Whatever the frequency of collection, we can certainly agree that there ought to be a possible coordinated interchange of information among exchanges and regulators that avoids duplicatoin of reporting.

That is the kind of differences we have between us. I believe they are not in opposition to the entire bill, nor are they in agreement with it. There are just levels of differences.

Senator **Dodd**. We have got some work to do.

Mr. **Melamed**. Yes.

Senator **Dodd**. Senator Gramm.

Senator **Gramm**. Mr. Chairman, I want to be sure I do not belabor the obvious. I am tempted to jump into this debate about high-yield securities. I resent the name "junk bonds." If somebody made a billion dollars with that innovation, it must have been one powerful innovation. There must have been billions of dollars of jobs, growth, and opportunity created with it. I resent it—that I did not make the billion dollars instead of the fellow who came up with the idea.

But rather than taking a lot of time in the committee's deliberation, let me just pose a couple of general questions.

As a general principle, are you satisfied with our current regulatory system, and do you believe we need any substantial changes in the laws that relate to the regulation of the equity security commodity markets?

Why don't I start with you, Mr. Melamed.

Mr. **Melamed**. To your first part of the question, yes, I'm satisfied. Do we need any major substantive new legislation? The answer is, no.

Mr. **Hardiman**. Yes, and no.

Mr. **Phelan**. As a regulator, you are never satisfied. You are always looking for more. I think that the legislative package that is here before the Senate speaks to the specific items; but I do not think that you need any pervasive legislation pertaining to the system.

As a matter of fact, what we are trying to do is to get the system to work with what we have in place, and have the rules work better than they do right now.

Senator **Gramm**. Let me pose a question related to the large trader reporting proposal. As I read the bill, basically it sets up a system whereby, for example, you might have large trader reporting from the futures market to the SEC, not the other way back. I guess you would want to do it in both directions, if you wanted to do it.

But let me again just stay general on it. Is there a problem now in the market, as it is functioning today, with sharing of information? Is there information that is needed that is worth trying to gather, given the impact of imposing costs to collect it?

That is to say, given the problems of proprietary interest, given the potential problems in handling such information, are we creating more problems with this effort to generate all this new data than we are solving? That is what I am asking.

Mr. **Phelan**. I am not talking about inter-market, but intramarket, in the reconstruction of what happened in October of 1987 in the equities market. We need more information available.

It is silly that it takes as long as it does to know who sold and what they sold.

Senator **Gramm**. But to be used within that market, not among markets?

Mr. **Phelan**. That is to be used within that market. I think we need that within our own market. I think in the exchange among markets that the Intermarket Surveillance Group does an excellent job of that. And the futures exchanges are now sitting in not as official members, but at least as participants.

But we, ourselves, and the NASD, for instance, for a number of years have shared data back and forth on a regulatory basis. If they have an investigation underway, we get from our files what is there, and they can actually access the ISIS files and those kinds of files when they want to, themselves.

We are beginning to incorporate a good bit of the options market in that as well and, as I say, the futures market. That works very well, but that does not speak to this bill here.

I look at this bill as being specific in nature, and with much greater reporting for the equities market. And you just ought to know something more about that, without being burdensome. That is why I can tell you that we suggest that the firms keep the information and that it only be called up when it is needed and in an important situation such as October of 1987.

If we had had it then, it would have been a lot easier to put it all together much quicker than it was for us.

Senator **Gramm**. Mr. Hardiman?

Mr. **Hardiman**. In fact, I think the firms do have it in their records today. It is a question of timing, and getting to that information, in terms of facilitating investigations of market manipulation and market abuse.

Since October 1987 we have introduced into the equity markets something known as "electronic blue sheeting." The information previously was requested on specific customers on what is known as a blue sheet.

That used to be compiled and submitted manually by the member firms, to the New York Stock Exchange and the NASD. Today, that is done electronically, by a rule among the various markets, within ten days.

So I think there are some significant changes that have taken place. Talking with our market surveillance people as recently as this morning, we have had absolutely no problems with getting information from our members in response to specific inquiries. And in fact, most times they beat that ten-day requirement by a significant margin.

We are able to get the focused information that we want in response to the specific inquiry, without, I think, having to ask our members to compile a large body of data and to maintain that data over and above what is already in the customer records.

Senator **Gramm**. Mr. Melamed?

Mr. **Melamed**. Senator Gramm, this is a good instance where the futures markets have had this regulation all along. We have had large trader reporting, and indeed it works very well in our market. We do not feel we need any additional regulation.

We certainly would not oppose a similar kind of regulation for the securities industry. The only concern we would have is that our market not be subject to duplicative reporting or that the data to be used in a different fashion than we use it today.

Senator **Gramm**. Let me be sure I understand this, now. Basically, what you are saying is that your markets already have it. The equities markets want to have it for their own internal use. And if they in fact have it, it could be shared when needed, and that is enough. Is that right?

Mr. **Melamed**. Yes.

Senator **Dodd**. That is basically what we are trying to get at here.

Senator **Gramm**. So basically, if I hear everybody right, we do not need all the paperwork, we do not need all the formalization. If each of the markets has it, they can share it.

Does it alarm you all that these regulators have not met in this taskforce? It always scares me when regulators meet. [Laughter.]

Mr. **Melamed**. That would have been my comment.

Mr. **Hardiman**. I think there is something that has been salutary about the participants in the Working Group getting together in 1988, which they did. I do not know with what degree of frequency, but on several occasions, I think it gave them an opportunity to know and understand not only each other's markets better, but also each other better.

That is something we are missing this year. I understand there have been other issues on the table for the Treasury Department to consider which may be much more pressing in terms of their impact upon the country, and upon investors and savers.

But I think it would be highly desirable to see the regulators meeting on a basis of not less frequently than quarterly. We do that among the self-regulatory organizations. We meet on a quarterly basis. The heads of all of the equity markets get together on a quarterly basis. We sit down and talk about common issues, common problems. And I think these meetings have been very constructive.

Mr. **Phelan**. I would support that, as well. The meeting of the markets themselves on a quarterly basis has worked out very well. I think that everybody gets to know each other better, that you begin to realize you have the same kind of problems, you begin to share the solutions, you begin to exchange information, and all the rest of it.

I think the reason that the Working Group, aside from being busy—I think that each of us has told the Working Group in the latter part of 1988 what we were about, and how long it would take to accomplish that. And that is probably why they have not met on the other things; they thought that that was sufficient.

Senator **Gramm**. Thank you, Mr. Chairman.

Senator **Dodd**. I have just received word that Chairman Ruder of the Securities and Exchange Commission is announcing his resignation at this very moment. I can just tell you, as someone who has taken over the subcommittee, I have not had the lengthy opportunity that Chairman Riegle has had to work with him. Anyway, he is a wonderful public servant. I just hope the administration will name a successor soon. We do not have a lot of time to buy.

Mr. **Hardiman**. We concur with that, Senator, and we support your favorable comments about the chairman. I think he has done an outstanding job under difficult circumstances. We, too, will miss him, and we hope there is not a vacancy at the top of that very important agency for any extended period of time.

Mr. **Phelan**. I would like to echo that as well. I think he has done an outstanding job. He came in at a very difficult time, and he has done a very thoughtful and I think a very good job.

I think we are all going to miss him, and we hope we will have somebody of his caliber there.

Mr. **Melamed**. Let me underscore that Chairman Ruder did an outstanding job, having come into office at that moment in time as chairman of the SEC. It was probably the most difficult thing that anybody could do, and I commend him.

Chairman **Riegle**. Mr. Chairman, I just want to take a second to add my thoughts to those, and express my admiration for David Ruder and the job he did. I always found him to be honest and direct in his dealings, and very forthright here as a witness before this committee.

I would like to underscore the point Mr. Hardiman just made, and that is that it is essential that the Administration move thoughtfully and quickly to replace Mr. Ruder, and also to select the rest of the members that are going to serve on the SEC.

This is not a time to let that SEC ship run without a good strong pilot up there at the wheel. So I would hope the message would go out from the professional community and from this committee that we would really like to see the Administration move at due speed on this one.

Senator **Dodd**. Senator Heinz.

Senator **Heinz**. Mr. Chairman, let me just state, as to Dave Ruder's resignation, which as I understand will be effective in August, that he has provided a tremendous service to this country in one of its most difficult periods, probably the most difficult period since the crash of 1929.

He has been a voice of enormous reason. He has been thoughtful. He has been bold when it has been necessary. Those would be very good measures which the Administration should use in selecting a new chairman of the SEC.

I am deeply concerned that there will not be a nomination suggested or down here in the near future. Indeed, I have it on fairly good authority, having talked to the White House as recently as last week about the status of potential selections for that job, while making clear that it was not my wish for Mr. Ruder to resign, indeed to stay, that they are a long way from selecting anybody.

I hope that they will not take much longer, because the clearance process is lengthy, it is burdensome, and I would hate to see us go into October 19, 1989 without a chairman of the Securities and Exchange Commission.

So if any encouragement is needed, let this be it. We need a chairman nominated, and we need a chairman, I hope, down here and confirmed no later than our August recess.

Mr. Chairman, obviously the reason we are here is to ensure, through our oversight and through our attention to the legislation proposed by the SEC, the fair and orderly operation of the securities markets, while restoring and then we hope maintaining investor confidence. That is much easier to say than to do, as we have learned this morning.

There is one issue that has come up that certainly is relevant to investor confidence, and it goes all the way back to October 19th, and that is the subject of clearance and settlement.

I have noticed that everybody has kind of mentioned it, tip-toed around it probably. It is too technical a term. Everybody has mentioned clearance and settlement, but nobody has said anything about clearance and settlement. So, at the risk of treading where about a dozen angels have feared to tread, I think we had better ask some questions about all of this.

The Brady Commission report did indicate that the delay and uncertainty about payments by several clearing members of more than one clearing organization—as you know, the Merc. was one of them—were detrimental, and threatening the public confidence in those institutions.

Is there anybody here who disagrees with the proposition that there were some serious problems in clearance and settlement during the market crash? Is there anybody who disagrees with that? [No Response.]

Senator **Heinz**. Nobody disagrees. Let the record show that all three of our witnesses agree, with some qualification apparently.

Mr. **Melamed**. The only qualification being that you understand that the crash was a unique and unusual occurrence. It was not what one would call a normal situation. Obviously, as a result of the abnormality that we experienced that day, one cannot say that there were no problems. In the context of that unusual day, I would agree.

Mr Hardiman. Senator, I might add one caveat. To put clearance and settlement into perspective, a lot of progress has been made in the United States since the days of the late 1960's, when everything was on a manual system and we were unable, as an industry, to process 10 million sharedays. Today, routinely we process a volume of 170 million to 200 million sharedays.

In, terms of clearance and settlement, we have come a long way. During the days of October 19th and 20th, I do not think there were problems with the mechanics of clearance and settlement, per se. It was more the credit risk of the participants in the process.

Senator **Heinz**. That is right. And on the intermarket trades; was that not correct?

Mr. **Hardiman**. That is correct.

Senator **Heinz**. In a sense, how far removed are we; were we to have another similar catastrophic day in the market, to reliving some of those same intermarket clearing problems? Mr. Hardiman, I agree with you that the intramarket operations are amazing, and quite efficient. But compared to where we were merely a year and three-quarters ago, how far advanced are we in dealing with the problem of the intermarket clearance and settlement problems that we all know existed?

Mr. **Phelan**. Senator, I think that is what I suggested before. Perhaps there ought to be a study done of what is in place today, the strength of what is in place today, and what might be needed to improve that.

I suggested that maybe the Working Group could undertake that. I think that there has been some progress made in cross margining and other areas. Again, with the sharing of information, there probably could be more done in that area.

One of the things that is very difficult to assess is, what happens if you have a major failure within the clearance process itself, and how do you get liquidity into the system until you get over that failure.

So in answer to your question, I think that still exists today, and will continue to exist, because you cannot guarantee that you will not have a failure within the system. The real trick is, how quickly does everybody know about that failure, and how quickly can you get some instant liquidity into the system so that the system can adjust to that failure itself and get itself straightened out?

Senator HEINZ. John, as you know, the SEC—and by the way, your suggestion that maybe there needs to be kind of a Brady-II report may be a good point—but the SEC has looked at it. When Dave Ruder was here, he talked about it.

It is the SEC's view that the clearance and settlement title of S. 648 would address these residual concerns. Of course, it would do so by directing the SEC and the CFTC to use their existing authority under federal law to facilitate greater coordination in clearance and settlement, thereby to reduce intermarket cash flows.

My question is, is that wrong?

Mr. HARDIMAN. My answer is, no. We support that provision of this bill. We believe it is a correct remedy, one correct step toward bringing not only information sharing but also some oversight into the intermarket clearing and settlement process.

Senator HEINZ. Will it? If it is not wrong, will it suffice? Does it go far enough? Does it need enhancements, improvements?

Mr. HARDIMAN. Clearance and settlement is obviously not a simple subject. It is hard to say whether it would suffice. I think it is a first step.

There are other issues coming into play, and that is the internationalization of the market, which John referred to earlier, and the inter-relationships not only between the U.S. markets, but also the U.S. markets and overseas markets, and trying to piece all that together, which the Group of 30 is certainly trying to do as far as the equity or cash markets are concerned.

It is interesting that they do not address the issues in the options and the futures markets, so I am not sure what is happening at that level. I think the study that John called for, where we would focus not only on the intermarket issue domestically, but also the international markets, is appropriate.

Senator HEINZ. Mr. Chairman, my time has expired. I do have one additional question, but it is time for a second round.

Senator DODD. We have covered the large trader reporting issue. Let me jump to one other. If we have some others, we perhaps will submit some questions to you.

The other one that seems to generate a great deal of interest is the provision for risk assessment for holding companies. Mr. Phelan, you support the provisions of the legislation which would give the SEC authority to require the reporting of information concerning financial or operational risks within holding companies, systems involving SEC-registered broker-dealers.

Mr. Hardiman, again, in your testimony you take a different point of view, as I understand it. I wonder if you two might discuss this, the rationale for your two different positions; why, John, you think it is important and, Joe, why you are opposed to it.

Why don't we begin with you, John.

Mr. PHELAN. I approach it from a systemic point of view. It is not that you can avoid the problems, if you know something about them, but you certainly cannot avoid them if you do not know anything about them.

I think one of the things that we have found very difficult in the 1980's is, with all the new products coming on, both domestically and internationally, how to assess the risks within those products.

We have had a number of accidents domestically, that have not sunk the system, but certainly have sent a shudder through it. We had some problems, and the Treasury market was stripped, and in redemptions we had some significant problems, and in the mortgage-backed guarantee market, and so forth.

There is so much financing being done, there are so many new products being traded to the holding companies, both domestically and internationally, that I think it just makes sense, without being overly burdensome about it, to get a better understanding about what is trading there, and how the firms are assessing those risks, and whether in fact there is cause for worry on a systemic basis.

Having said that, there is a lot of innovation, and we talked about this before. It is what we have called intellectual proprietary products. There are a great numbers of innovations that the firms would not like their competitors to know about, as to how they are doing, what they are working on, and what they are developing.

I think a great deal of concern is expressed by the firms in that area, and I think rightly so. So there has to be an assessment of risk. But at the same time, I think that you have to keep those proprietary products that they are working on from their competition as well. That is why I think there has to be a balance.

Systemically, I think it is certainly worth doing, because if you ever had a major systemic problem and nobody was looking at it, we would all kick ourselves for that. We just have to be careful that we do not impose such burdensome requirements that it stifles creativity and entrepreneurship and that it is overly expensive.

Mr. HARDIMAN. Just to address quickly the systemic issue that John raises, he in fact is correct in his assumption that it could have significant impact upon failures in the future.

Then, I think the exemptions in the bill itself call into question whether we would get the information that we really need, and get it on a timely basis where you could act upon it, because we are exempting many of the financial institutions that do have broker-dealer affiliates in their holding companies.

Two, if you are going to exempt those on the basis that there is public information available, I do not understand why you would not also exempt Section 12 reporting companies, under the 1934 act, because the same types of information are generally available in terms of their reports and their requirements for reports.

So I question whether you are really going to get at the systemic issue John raises, because of the numerous exemptions to the bill.

Going back to the confidentiality issue, I think that is a key issue. There are a number of firms that have broker-dealer affiliates, and they are no longer just in the financial institutions area. I refer to companies like Sears, GE, and American Express, that are significant factors in our marketplace, as well as to the number of international financial institutions that have broker-dealer affiliates.

We have over 50 members of the NASD that are affiliates of international financial institutions, and I wonder what the impact upon their continuing to participate in our markets would be.

Lastly, we do have capital rules under the 1934 act. Those capital rules were developed by the SEC and the selfregulatory organizations over an extensive period of time. They are thorough. They are complete. They do allow for an analysis of the financial statements of the broker-dealer, in which everything must be disclosed, and if there are receivables that do exist from the affiliates and holding companies, we already have the authority to look through those, to question the value of those receivables.

So I am not sure that this legislation is really needed. If it can be demonstrated that there is a need, we certainly are open-minded.

Senator DODD. You look like you wanted to comment. I would like your comment.

Mr. PHELAN. Joe commented on one important thing. In many of these areas it is getting so complicated that it is rising above the level of ability to regulate. This is clearly one of them because it depends on how you define a holding company, and I think Sears is a perfectly good example of that, General Electric and any of the others.

What is it that you are going to require from them and how do you do it? Who gets that, who shares that information, and so forth?

So it is not a simple question.

Mr. HARDIMAN. It is not only what you ask for. It is what you do with it after you get it, and that is the level of our concern.

Senator DODD. You mentioned earlier the SRO's, the agreements that have sort of been reached by and between various markets.

Are there areas where you have not been able to come to agreement? You talked about the ones where you have reached agreement. Are there some areas in that category that you just see it as being rather difficult; you have tried and it doesn't seem to be working out?

Mr. MELAMED. Well, if I might mention one area. We have done well in developing a cross-margining system with options, as has been mentioned. This was certainly one of the major recommendations as a result of the Brady report.

We would like the ability to share pay-and-collect information on a day-to-day basis with the OCC. While we have achieved it with our futures market participants, we have not been able to achieve the sharing completely with the Options Clearing Corp. We would like to move further in that direction to accommodate that kind of information flow.

Senator DODD. Joe.

Mr. HARDIMAN. Probably two areas that I think we are still discussing—and I say discussing—but we haven't been able to come to any resolution at this stage of the game. One involves the so-called Intermarket Trading System, which was the industry's response to the congressional mandate in the 1975 act to facilitate trading in securities among different markets.

There are a number of mechanical features in the ITS that we and the regional exchanges find to be cumbersome. We are attempting to resolve those issues with the New York Stock Exchange. Thus far we haven't been able to do so.

Second, in an area where I know John and I have had conversations—he will love me for bringing this up—the issue of arbitration. I really believe that in light of all the questions that are being raised about the arbitration process, in light of the recent Supreme Court decisions, that our arbitration process does work and works well, but there would be a greater perception of fairness to all investors if we had a single industry arbitration forum rather than each market operating its own arbitration forum and that the governance of that forum should have broad representation from the general public.

Senator Dodd. John, do you want to comment?

Mr. Phelan. To the ITS issues? I am not sure what specifically he is talking about, but I assume we will work those out.

As to arbitration, we run an arbitration facility. Joe runs one. We all agreed to the new rules and the changes that the SEC proposed. We get our cases through in an average of about eight and a half months now. The arbitration facility for us is working reasonably well. We don't have capacity problems or other things.

I am not sure that having one single arbitration forum for the entire industry is going to solve any problems or make the process less expensive, but we are not particularly hung up on that area. If that is what the Commission wants, we will be willing to cooperate.

Senator Dodd. Thank you very much.

Let me turn to Senator Heinz.

And, by the way, I am fully aware that you have a flight you have got to catch. So if the time arrives, don't feel compelled to sit there if you have to move along. We will try and wrap up quickly.

Senator Riegle.

Chairman Riegle. Mr. Chairman, just one item I want to raise. I know Senator Heinz has other issues that he wants to get into.

I would like for the record, if there are any outstanding issues—I know it is late in the morning and you have been at the table a long time, but in terms of the discussions to try to resolve differences which have produced a number of understandings, with anything that is left up in the air I would like you to summarize in writing and give us some sense as to when we might expect those issues to be resolved or if you feel that they are just not going to be able to be resolved. I would like to really have a nice, tight summary of where we are so it doesn't kind of fade off out of view here.

Finally, this, Mr. Melamed, and that is after the crash I know the Merc raised margin requirements—we have talked about this before—on stock index futures. I noted that the requirements have come down twice, at least twice, most recently earlier this month, and as I understand it, the maintenance margin as a percent of the S&P Index is now lower than it was before the crash.

I would like you to tell me if my information is right and, if so, what is the thinking on why the lower margins for that?

Mr. **Melamed**. Well, Senator, the 77 or so studies that were conducted after the crash entertained all of the possible factors that were thought might be a factor in the crash. In none of them, including even the Brady report, was there evidence that would lead to the conclusion that futures margin was a factor in the crash.

I point that out because, as you are aware, there was the perception,which lingers still that futures margin was that influencing factor. That simply was not born out by any of the evidence.

While I know we discussed the function of futures margin at great lengths, it bears repeating that futures margins operate on a mark-to-market basis. In effect, any change in contract value is paid in cash on a daily basis. Therefore futures margin, in contrast to securities markets is but one small factor of the overall financial requirements.

And, as Chairman Greenspan indicated in the Working Group—and I quote him—he said, "I believe we should not be guided in the margin area by equalization for leverage reasons."

Simply stated, margin in futures has an entirely different function than what is known as margin in equities. According to the Working Group, futures margin should be prudential. We certainly endorse and agree with that view. It was the overwhelming evidence that our margin, in terms of the volatility and risk factors in the market today, was far too high; so proportionately out of line that our market could not be used by even that small percentage of retail users that seek to use the market.

As you understand, most of our market is not retail, and it is not affected by this recent margin change whatsoever. Our market is used primarily as a hedge market which has a different margin structure. That margin structure was not changed.

The segment that this margin change would apply to is perhaps no more than 7 percent of our market. Moreover, we didn't change the "maintenance" margin involved. It still remains the $4,000 that it was from the first days after the crash.

So, in effect, what we were doing is putting ourselves in line with all the margin structures in the nation as well as in the world. I must point out that if you consider the other futures markets' margins—the New York Futures Exchange, the Chicago Board of Trade, or any other exchange in the world that deals in stock index products—they were maintained substantially lower than ours over this 2-year period. Our market suffered dearly as a result of this, and that was unconscionable in this reduced volatility environment and in the international competitive atmosphere that exists. Our own research indicated that our margins should be substantially below what, in fact, our Board authorized. We did not go to the lower level recommended which was justifiable in terms of potential risk evaluation. We went to a level above that.

So from that point of view, we certainly feel that we were in every way correct and commensurate with all our ideas about our margin structure.

Chairman **Riegle**. Thank you, Mr. Chairman.

Senator **Dodd**. Thank you.

Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

I guess I have this question mainly for Leo Melamed. It has to do, Leo, with an innovative new product—I think you know it well—called index participations. It was a product that, as I understand it, the Katzenbach report in December 1987, and the SEC market break study, in February 1988, recommended for introduction. It is a basket type stock product. The reason, I understand, that they recommended its development and production was that it would take some of the pressure that was on the futures market on October 19th and at other times as a means of taking some volatility out of the marketplace.

The SEC approved trading of index participation sometime ago, but until last week they had stayed their approval because of litigation commenced by both the Board of Trade and the Merc challenging the SEC's authority to regulate trading.

Now, my question is really severalfold, I suppose. One question is, are the securities and commodities laws unclear as to which agency has the authority to regulate this product, and whether or not that is true, isn't it from a public policy standpoint the most important goal that innovative products—and I might add, particularly those that enhance market stability—be developed and traded? Therefore why shouldn't what the Merc and the Board of Trade have done basically be viewed as measures simply to protect one's turf even at the cost of retarding the development of new and strongly recommended products?

Mr. MELAMED. Senator Heinz, that is a very, very good question. I am very pleased to have an opportunity to respond to that because, as a matter of fact, I would like, at least to the extent possible, to alleviate any confusion.

We endorse the Brady report in terms of the creation of a basket type product in equity markets and I believe the New York Stock Exchange is, and has been, working on such a product. Certainly we would have no objection and would commend them for it if in fact other exchanges are working on equity basket products.

The point to understand is that the so-called CIPs, VIPs, and EIPs are futures contracts. We would have no objection if they were launched after application to and approval by the CFTC. Indeed, the American Stock Exchange and the Philadelphia Stock Exchange have futures market counterparts and could have easily applied to the CFTC. We know of no reason why the CFTC would not approve them, and we would have no problem with it.

Senator HEINZ. That is a point to understand. We are all in trouble.

Mr. MELAMED. We are all in trouble.

Senator HEINZ. Why should they apply to the CFTC?

Mr. MELAMED. Because it is a futures market contract. It walks like a duck, it talks like a duck, and we assume that it therefore should be a duck.

Senator HEINZ. At least to date, the CFTC has registered no objection.

Mr. MELAMED. The CFTC has registered objections, Senator Heinz.

Senator HEINZ. They haven't gone to court.

Mr. **Melamed**. The CFTC has submitted objections to the SEC, and have advised us that they are certainly objecting.

Senator **Heinz**. Why did they not go to court?

Mr. **Melamed**. I don't know that I can answer their motivation, but they have submitted a letter to the SEC, and I believe they either intend or will submit a letter to the court.

Senator **Heinz**. You know, I think this somehow begs the question. What you are saying is you have got a product that everybody I have talked to says is a close call. It looks like a duck, it walks like a duck and talks like a goose, it walks like a goose. I mean, it is certainly a security of some kind with various other characteristics.

What seems to me to be happening is that the courts are being asked to decide something that either ought to be left to the market or the Congress, and since we haven't done anything, why not just leave it to the market? What harm will be done by allowing—whether it is Chicago or Philadelphia—to trade this product as long as there is somebody looking over their shoulder?

I mean, that is what we in Congress intend, is that somebody look over the shoulder. That is certainly being done by the SEC.

Mr. **Melamed**. Simply, the rules with respect to the trade of instruments in futures and those rules as they apply to securities markets are different. This creates a different playing field in terms of the regulatory requirements. The requirements for futures markets are more difficult than they are in securities.

I don't want to go into the depth of that difference, but if, indeed, the differences are such that the American Stock Exchange and the Philadelphia Stock Exchange could have lived with those differences—I ask the question sort of in return—why didn't they apply in the futures market? Why did they choose to do it the way they did and in fact knew that they would draw this problem when they could have avoided it and there would have been no objection from our industry?

Senator **Heinz**. Your objection, as I understand it, is not that they applied to the SEC. Your objection is that the SEC approved the product.

Mr. **Melamed**. Of course, but this fight could have been avoided simply by application to the CFTC and approval.

Senator **Heinz**. Well, I will tell you, my view is that when you have got a product that has, if you will, gotten a repeated Good Housekeeping seal of approval and that the goal of the product, as established by study after study, is to make the markets less volatile, enhance investor confidence, bring those small investors back into the market who as of 1988 constituted all of 18.5 percent of the trading volume, it seems to me there ought to be a way of getting that product into the marketplace that doesn't rely on an interminable—and I do mean interminable—series of court proceedings, appeals, reappeals that has the net effect, whether you mean or not, to keep that product out.

Mr. **Melamed**. I think I agree entirely with what you are saying except for the fact that this is not a basket of stocks. It is a contract based on the value of an index, which is the exact same thing we trade in futures. Therefore, this whole problem could have been avoided by simply following the direction of the Shad-Johnson agreement.

Senator HEINZ. Mr. Chairman, thank you. My time has expired. Leo, thank you very much.

Senator DODD. Let me thank all three of you. This has been a long time for you to sit here, almost 3 hours, but I personally appreciate it very much, and I know I speak for the members of the subcommittee as well and the Chairman of the full committee.

We will have some written questions for you. We covered, I think, the major points, but there are a couple of other areas in the legislative package on which I would like to get your comments, and particularly in the case of Mr. Hardiman, areas where you think these proposals can be improved. There may be some provision you just think bad ideas, but to the extent you think certain changes would make the legislation workable, please let me know what they are.

The last thing we want to do, as we try and restore confidence and minimize the risks which we all agree are potentially there, is to discourage the kind of innovation that the markets have to have if they are going to thrive and provide economic growth and security for this country.

Senator DODD. I thank, again, all three of you for being here with us this morning, and we look forward to seeing you again.

Our second panel consists of Mr. Jeffrey B. Lane, president and chief operating officer of Shearson Lehman Hutton in New York and George S. Bissell, chief executive officer of Keystone Massachusetts Group from Boston, MA.

Mr. Lane, Mr. Bissell, we welcome you. We apologize for being a little late. I hope it was worthwhile listening to our three previous witnesses.

Let me inform you, the text of your full statements of course will be included in the record. For the purposes of efficiency and time, if you can summarize your major points, it would be very, very helpful.

Let me say something here that normally is not an expected comment. I want to personally tell you both how deeply appreciatively I received your testimony. So often we will get testimony that says I am opposed, and it may take 20 pages to do it or 30, but that is the message. Rarely do we get testimony that comes up and says I think you have got some problems here, I don't really agree with this but I have got some ideas of how you could make it better.

And I want to commend both of you who are taking that approach. As we try to move legislation, to the extent we get a good constructive suggestion on how to improve the legislative product, that is something every one of us on this side of the table feels is useful.

When we get that kind of testimony, it assists us tremendously and our staffs as we try and fashion intelligent and thoughtful legislation in this or any other area, for that matter. So at the outset I want to commend both of you for that approach. It is very, very helpful.

With that, let me again welcome both of you. Mr. Lane, we will begin with you, then Mr. Bissell.

STATEMENT OF JEFFREY B. LANE, PRESIDENT AND CHIEF OPERATING OFFICER, SHEARSON LEHMAN HUTTON, INC., NEW YORK, NY

Mr. **Lane**. Thank you, Mr. Chairman and members of the subcommittee. I welcome the opportunity to appear before you today to discuss measures that strengthen and stabilize our securities markets and prepare those markets for the future.

I am here because these issues have a direct effect on Shearson Lehman Hutton and its clients, and they are central to the strength and vitality of the United States and the world economy.

Last year I testified before the House Subcommittee on Telecommunications and Finance on most of these same matters. I emphasized both general economic and market specific concerns that we believe are key to building long-term stability in the stock market and to restoring investor confidence. Some of those concerns have been addressed to one extent or another, while others have not.

Let me begin by addressing S. 648, the Market Reform Act of 1989, which you, Mr. Chairman, and Senator Heinz introduced on March 17th of this year at the request of the SEC.

We support the basic principles of S. 648, but we have some concerns about the language in the current bill. We also believe that any market reform legislation must be carefully tailored to address the root causes of the October 1987 market crash, and in our view, S. 648 needs certain alterations to meet that goal.

With respect to section 2, SEC emergency authority and trading halts, we see this as a cornerstone of necessary market reform. The bill proposes a reasonable structure for emergency actions, and particularly trading halts. It meets our specific reservations about the prospect of suspending trading up to 72 hours by placing the ultimate authority for the suspensions beyond 24 hours in the hands of the President.

Section 3 grants authority to the SEC to adopt important rules to monitor the impact on the securities markets of large transactions and publicly traded securities involving a substantial volume or a large fair market value or exercise value. We support this objective, but Section 3 needs to address some additional and important concerns if it is to be effective.

First, although the authority to impose reporting requirements is similar to that already in place for commodity markets, there should be some recognition that the total securities accounts to be monitored could be vastly greater than the affected commodities accounts. For example, at Shearson Lehman Hutton we have 50,000 commodity accounts and over 6 million equity accounts.

We would favor either legislated thresholds which recognize differences between exchanges and trading activity levels, or a specific description of those factors which the Commission should use in setting thresholds.

We should all recognize that even with some reasonable limits a detailed reporting system will be so complex, time consuming, and expensive for broker/dealers, SRO's, and/or the SEC so that the timetable for setting up these systems should be flexible and reasonable. The actual reporting deadlines should also be flexible enough to assure that broker/dealers will be able to provide the

SRO's or the SEC with reliable information within a reasonable time frame.

It is also very important that the broker/dealer has sufficient time to review such information prior to submission to the SRO or the SEC.

Second, although the bill makes the large trader responsible for reporting large transactions, in practice the initial reporting will be done by the broker/dealers, probably by automated tape to the SRO's. We believe the bill should explicitly state that, other than for the failure to submit this initial report and for reporting transactions in which the broker/dealer is a large trader, broker/dealers will have no liability for a large trader's failure to report or its reporting misleading or inaccurate information.

Third, the bill should specifically address how accounts or transactions are to be aggregated for reporting purposes and clarify that the responsibility for aggregation rests with the large trader and not the broker/dealer.

Fourth, the large trader data should be exempt from any public disclosure by the SRO which has collected it.

As you consider how to deal with the large trader reporting issue, it is important to bear in mind that the SEC has new and unused enforcement and regulatory powers under the Insider Trading and Securities Fraud Enforcement Act of 1988. The act, which we supported and which was signed into law last November, imposes new responsibilities on broker/dealers and investment advisers to prevent insider trading and new penalties for failing to uncover such trading.

Together with the recent New York Stock Exchange and NASD initiatives in this area, these measures should contribute to curbing the insider trading abuses we have seen in our industry during the last several years.

Large trader reporting requirements have a legitimate purpose, but they can also involve significant downside risk. In a time of rapidly expanding international trading of U.S. securities, this legislation must be drafted carefully to avoid the counterproductive effect of forcing more securities business offshore.

Section 4 of S. 648 clarifies the SEC's authority to require reporting by holding companies regarding the financial or operating conditions of persons associated with those entities, if the SEC believes the activities of those associated persons are reasonably likely to have a material impact on the finances or operations of the broker/dealer or holding company. The legislation authorizes the collection of significantly more material than the SEC collects under current law.

The SEC has indicated that this authority will allow it to examine a wide range of new and possibly proprietary information and familiarize itself with policies and risk assessment procedures of broker/dealers that are part of holding companies.

Like the large trader reporting proposal, the goal of this section is a positive one. But we see a real need for improving the current language. The bill should be explicit and specific about the types of information to be reported and the time and format for reporting it. The criteria for exemptions should be described in more detail in the bill.

It is also very important that this legislation make it clear that associated persons not primarily engaged in broker/dealer activities, including government and municipal securities broker/dealer activities, should be exempt from the law.

Finally, the public disclosure prohibition in the bill should be strengthened to make it clear that the SEC is prohibited from disclosing confidential data except to Congress.

Let me state that we would be pleased to work with you, the staff, and the SEC to develop language which will address the concerns I have noted in sections 3 and 4 of the bill.

Section 5 of the bill, which directs the SEC, the CFTC, and the Federal Reserve to cooperatively develop linked, coordinated, or centralized facilities for clearance and settlement, is a key provision that we strongly support. This will promote more comprehensive monitoring of overall risk exposures in the equity marketplace and facilitate setting margin rates which reflect each investor's risk exposure.

Some important and positive regulatory and private sector initiatives have taken place since the crash. Many firms, including Shearson Lehman Hutton, voluntarily agreed to stop program trading for their own accounts. In this same context, the New York Stock Exchange now requires daily reporting of all program trading activity by member firms.

We believe that these actions have helped lessen market volatility caused by program trading and allowed monitoring of program trading by the New York Stock Exchange.

You have asked whether we believe the level of international regulatory coordination is adequate. The answer would have to be not yet. We believe there have been generally encouraging developments, however.

We see the November 1988 SEC policy statement on the regulation of international securities markets as an important first step in this area, and we applaud it.

The SEC's goals in the area of international clearance and settlement have been embraced and elaborated on by the so-called Group of Thirty, a group of international private sector financial leaders, in its recently released report on clearance and financial settlement systems in the world's securities markets. The report makes nine recommendations designed to eliminate a number of deficiencies in current international clearance and settlement and sets a deadline of 1992 for implementation on its recommendations.

We strongly support the recommendations and hope the deadline is met by the international securities community.

One of the other bills the SEC proposed, the International Securities Enforcement Cooperation Act, gives the SEC and the SRO's specific authority to use the rulings of foreign courts and securities authorities to sanction U.S. securities professionals. Given the rapid internationalization of the securities markets, this is long overdue. It will help promote U.S. investor confidence in our domestic markets.

The primary challenge for our markets will be to remain competitive. Careful regulation will restore and strengthen the confidence that U.S. and foreign investors have in our markets. However, excessive regulation can contribute to increased amounts of securities business being conducted outside the United States.

That is why it is important that the proposals to increase SEC authority and impose new requirements on the industry be handled cautiously. We must fully evaluate what impact they will have on the flow of capital and the resulting financial strength of U.S. markets.

Looking back over the past 18 months, there have been a number of positive developments in improving the regulation of our nation's securities markets. There are, however, a number of additional measures which are necessary, including legislation similar to S. 648.

We look forward to continued cooperation with you in this effort. Again, thank you for inviting me today. I will be happy to respond to any questions you may have.

[The complete prepared statement of Jeffrey B. Lane follows:]

STATEMENT OF JEFFREY B. LANE

PRESIDENT AND CHIEF OPERATING OFFICER
SHEARSON LEHMAN HUTTON INC.

BEFORE THE SUBCOMMITTEE ON
SECURITIES

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

UNITED STATES SENATE

May 18, 1989

Mr. Chairman and Members of the Subcommittee, I welcome the opportunity to appear before you today to discuss measures to strengthen and stabilize our securities markets and to prepare those markets for the future. I am here because these issues have a direct effect on Shearson Lehman Hutton and its clients, and they are central to the strength and vitality of the U. S. - and the world - economy.

Last year, I testified before the House Subcommittee on Telecommunications and Finance on most of these same matters. I emphasized both general economic and market specific concerns that we believed are key to building long-term stability in the stock market and to restoring investor confidence. Some of those concerns have been addressed to one extent or another, while others have not.

First, let me say that the U. S. economy continues to demonstrate a strength and resiliency that is remarkable. As our economic growth has begun to slow a bit, markets have adjusted relatively well. The budget agreement now being debated here in Congress is a step toward reducing at least one of our serious twin deficit problems. Unfortunately, it appears we will continue to struggle for further reductions in the trade deficit for a long time. Efforts to reduce both of these fiscal burdens must continue.

Economic fundamentals ultimately dictate where stock prices go. But on October 19, 1987, the sudden, steep and ominous plunge in the stock and futures markets was not simply the product of economic fundamentals. Market mechanisms, including financial instruments, trading strategies, and regulatory structures have all been cited as major, contributing factors in that event. So despite the strength of the post-crash market, there are still real risks. We ought to be sure that mechanisms are in place to avoid any repeat of October 19, and while we have started that work, there is much more to do.

I want to comment today on the questions posed in your May 1, 1989 letter to me, all of which bear on these key issues.

Let me begin by addressing S. 648, the Market Reform Act of 1989, which you, Mr. Chairman, and Senator Heinz, introduced on March 17 of this year, at the request of the SEC. We support the basic principles of S.648, but we have some concerns about the language in the current bill. We also believe that any market reform legislation should be carefully tailored to address the root causes of the October 1987 market crash, and in our view S. 648 needs certain alterations to meet that goal.

With respect to Section 2, SEC Emergency Authority and Trading Halts, we see this as a cornerstone of necessary market reform. The bill proposes a reasonable structure for emergency actions, and particularly trading halts. It meets our expressed reservations about the prospect of suspending trading for up to 72 hours by placing ultimate authority for suspensions beyond 24 hours in the hands of the President.

Section 3 grants broad authority to the SEC to adopt reporting rules to monitor the impact on the securities markets of large transactions in publicly traded securities involving a substantial volume or a large fair market value or exercise value. When Chairman Ruder appeared before you on April 18, he testified that while the SEC has jurisdiction through the self-regulatory organizations to obtain broker-dealer trading records, these records frequently do not show the name of the ultimate beneficial trader. Chairman Ruder indicated that this kind of large trader information was needed for enforcement activity and to improve oversight of the markets, particularly in times of stress.

We support these objectives, but Section 3 needs to address some additional, and important concerns if it is to be effective. First, although the authority to impose reporting requirements is similar to that already in place for commodities markets, there should be some recognition that the total securities accounts to be monitored could be vastly greater than the affected commodities accounts, unless the threshold amounts are set at realistic levels. We would favor either legislated thresholds which recognize differences between exchanges and trading activity levels, or a specific description of those factors which the Commission should use in setting thresholds. We should all recognize that even with some reasonable limits, a detailed reporting system will be complex, time-consuming, and expensive for broker-dealers; so the timetable for setting up these systems should be flexible and reasonable. The actual reporting deadlines should also be flexible enough to assure that broker-dealers will be able to provide the SROs or the SEC with reliable information within a reasonable time frame if reporting is based on trade date and not settlement date information. It is also very important that the broker-dealer compliance department have sufficient time to review such information prior to submission to the SEC.

Second, although the bill makes the large trader responsible for reporting large transactions, in practice the initial reporting will be done by broker-dealers, probably by automated tape to the SROs. We believe the bill should explicitly state that, other than for failure to submit this initial report and for reporting transactions in which the broker-dealer is the large trader, broker-dealers will have no liability for a large trader's failure to report, or its reporting misleading or inaccurate information.

Third, the bill should specifically address how accounts or transactions are to be aggregated for reporting purposes and clarify that the responsibility for aggregation rests with the large trader and not the broker-dealer.

Fourth, the large trader data should be exempt from any public disclosure by the SRO which has collected it.

As you consider how to deal with the large trader reporting issue, it is important to bear in mind that the SEC has new and unused enforcement and regulatory powers under the Insider Trading and Securities Fraud Enforcement Act of 1988. The Act, which we supported and which was signed into law last November, imposes new responsibilities on broker-dealers and investment advisers to prevent insider trading, and new penalties for failing to uncover such trading. Together with the recently adopted New York Stock Exchange rule that requires member firms to make regular, periodic reviews of employee and proprietary trading and to report on any irregularities, and the NASD initiative increasing the supervisory responsibilities of member firms, these measures should contribute to curbing the insider trading abuses we have seen in our industry during the last several years.

Large trader reporting requirements have a legitimate purpose, but they can also involve a significant downside risk. In a time of rapidly expanding international trading of U.S. securities, this legislation must be drafted carefully to avoid the counterproductive effect of forcing more securities business offshore.

Section 4 of H. R. 648, clarifies the SEC's authority under Section 17 of the Exchange Act of 1934 to require reporting by holding companies regarding the financial or operating conditions of persons associated with those entities, if the SEC believes the activities of those associated persons are reasonably likely to have a material impact on the finances or operations of the broker-dealer or the holding company. The legislation authorizes the collection of significantly more material than the SEC collects under current law.

The SEC has indicated that this authority will allow it to examine a wide range of new and possibly proprietary information, and familiarize itself with the policies and risk assessment procedures of broker-dealers that are part of holding companies. Like the large-trader reporting proposal, the goal of this section is a positive one. But we see a real need for improving the current language. The bill should be explicit and specific about the type of information to be reported, and the time and format for reporting it. The criteria for exemptions should be described in more detail in the bill. It is also very important that this legislation make it clear that associated persons not primarily engaged in broker-dealer activities including government and municipal securities broker-dealer activities, should be exempt from the law. Finally, the public disclosure prohibition in the bill should be strengthened to make it clear that the SEC is prohibited from disclosing confidential data, except to Congress.

Let me state that we would be pleased to work with you, the staff, and the SEC to develop language which will address the concerns I have noted in Sections 3 and 4 of the bill.

Section 5 of the bill, which directs the SEC, the CFTC and the Federal Reserve to cooperatively develop linked, coordinated or centralized facilities for clearance and settlement, is a key provision that we strongly support. This will promote more comprehensive monitoring of overall risk exposures in the equity marketplace, and facilitate setting margin rates which reflect each investor's risk exposure.

You have asked whether we think S.648 sufficiently addresses the problems revealed in the October 1987 crash. I would reply that the bill alone does not sufficiently address the causes of the crash. We believe that three major reforms that we supported in last year's legislation are still needed - unified regulation of interrelated markets, unified margin requirements for all equity and equity related products, and clearer standards on frontrunning.

Some important and positive regulatory and private sector initiatives have taken place since the crash. Many firms, including Shearson Lehman Hutton, voluntarily agreed to stop program trading for their own accounts. In this same context, the New York Stock Exchange now requires daily reporting of all program trading activity by member firms. Each month the NYSE releases a summary of all program trading activity by its members during the month. We believe that these new actions have helped lessen market volatility caused by program trading, and allowed monitoring of program trading by the NYSE.

In my testimony last year, I supported the creation of reasonable circuit breakers to limit market volatility. I suggested that the exchanges should implement these measures. Last year the major securities and commodities exchanges approved a one year pilot program of coordinated circuit breaker procedures that provide for a one hour trading halt after a 250 point decline in the Dow Jones Industrial Average and a two-hour trading halt after a 400 point decline. Since these circuit breakers have never had to be used, we do not know what effect they would have on market volatility, but they are a welcome experimental step.

We also support the recent NYSE/Chicago Mercantile Exchange circuit breaker rules in the area of program trading.

Those rules provide that when the Standard & Poor's futures contract drops more than 12 points below the previous day's close the CME will halt trading in that contract for 30 minutes. At the same time the NYSE will route program trading-related market orders in S&P 500s stocks entered through the Exchange's automated order entry system to a "sidecar" for five minutes to remain unexecuted until it can be determined if there is a significant order imbalance.

When I testified last year, I stated that we welcomed the actions that the NYSE had taken to increase specialist capital. In January of this year, the SEC proposed a new rule subjecting specialists to the same net capital rules as broker-dealers. We support the proposal, because it will provide additional certainty that specialists are sufficiently capitalized to meet the more demanding and rapidly changing trading environment on the exchange.

Shearson Lehman Hutton is also a leader and a major participant in the Over-the-Counter market, making a market in approximately 2,500 NASDAQ listed stocks. We supported the June 1988 NASD changes to its Small Order Execution System or SOES that made market-maker participation in SOES mandatory, and permitted SOES order execution in particular securities even when markets are crossed and locked, as was the case on October 19. In addition the NASD introduced a new automated system known as OCT after the October crash. OCT allows firms and market-makers alike to enter and execute orders mechanically without having to transmit the orders by telephone.

Notwithstanding these welcome initiatives, we still need unified regulation, unified margins, and frontrunning standards, as well as much of what is in S. 648. These are all necessary to address adequately the shortcomings of market mechanisms and operations revealed by the October 1987 market crash.

Unified regulation, in particular, was the focus of numerous private and government studies of the crash. Virtually all of these studies concluded that some single coordinating and regulating mechanism was needed for all interrelated markets. We strongly support this recommendation, and believe the appropriate agency to do this is the SEC.

You have asked whether we believe the level of international regulatory coordination is adequate. The answer would have to be not yet. But there have been generally encouraging developments.

We see the November 1988 SEC policy statement on the Regulation of International Securities Markets as an important first step in this area, and we applaud it. The Policy Statement clearly sets out the three essential features of an effective regulatory structure for an international market system. They are efficient and coordinated structures for international market operations (including clearance, settlement and payment), sound disclosure systems with an emphasis on high accounting standards, and fair and honest markets achieved through regulation of abuses, prohibition of fraud, and cooperative enforcement worldwide.

The SEC's goals in the area of international clearance and settlement have been embraced and elaborated on by the so-called "Group of Thirty", a group of international private sector financial leaders, in its recently released report on "Clearance and Settlement Systems in the World's Securities Markets". The report makes nine recommendations designed to eliminate a number of deficiencies in current international clearance and settlement systems and sets a deadline of 1992 for implementation of its recommendations. We support the recommendations and hope the deadline is met by the international securities community.

In this regard, we applaud the announcement on May 16, 1989 of the formation of an industry group to review the recommendations in the report and establish a timetable for their implementation. We also believe that adoption of the clearance and settlement provisions of S. 648 will send a strong message to the global securities markets that the U.S. is serious about improving its own clearance and settlement systems.

As an outgrowth of the objectives in the Policy Statement, the SEC has undertaken a priority effort to work with international regulators to develop sound international disclosure systems for companies that want to raise capital in world markets. This will make it considerably easier for those companies to use the U.S. and other markets, and we hope it will move forward quickly.

Through the Policy Statement and other initiatives, the SEC has been demonstrating extraordinary leadership in continuing to press for increased international recognition and cooperation in all market regulation. We want this to continue - the U.S. must be a full participant and leader in an open and fair international marketplace.

One of the other bills the SEC proposed - the International Securities Enforcement Cooperation Act - gives the SEC and the SROs specific authority to use the rulings of foreign courts and securities authorities to sanction U.S. securities professionals. Given the rapid internationalization of securities markets, this is long overdue. It will help promote U.S. investor confidence in our domestic markets.

Your final two questions to me, concerning the challenges confronting the U.S. securities markets and the capital formation process in the next decade, and the adequacy of SEC resources, could take up a full hearing on their own. I will try to answer in a more focused way. The primary challenge for our markets will be to remain competitive. Careful regulation will restore and strengthen the confidence that U.S. and foreign investors have in our markets. However, excessive regulation can contribute to the increased amount of securities business being conducted outside the United States. That is why it is so important that proposals, to increase SEC authority and impose new requirements on the industry be handled cautiously. We must fully evaluate what impact they will have on the flow of capital, and the resulting financial strength, of U.S. markets.

The SEC and the SROs must have adequate resources to properly regulate the securities markets and perform compliance functions, and we generally support requests for additional resources. However, we have some concerns about Chairman Ruder's recent request for funding for a special Capital Markets Unit. Chairman Ruder testified this new unit could help prevent another market crash, and protect issuers and financial markets from other significant disruptions. While the goal is one we all share, we question whether the proposed unit is premature.

We believe the SEC's first priority should be to identify the root causes of the crash, and assess the extent to which recent SRO and private-sector initiatives have dealt with those problems and restored U.S. investor confidence. Only then can there be a proper determination whether there is any real need for a new SEC capital markets regulatory division. It is entirely possible that additional resources would best be used to strengthen the staff and operations of existing SEC divisions.

Looking back over the past eighteen months, there have been a number of positive developments in improving the regulation of our nation's securities markets. There are, however, a number of additional measures which are necessary, including legislation similar to S. 648. We look forward to continued cooperation with you in this effort. Again, thank you for inviting me today. I will be happy to respond to any questions you might have.

Senator DODD. Thank you very much, Mr. Lane. We appreciate again your testimony.

Mr. Bissell, we welcome you.

STATEMENT OF GEORGE S. BISSELL, CHIEF EXECUTIVE OFFICER, KEYSTONE MASSACHUSETTS GROUP, BOSTON, MA

Mr. BISSELL. Thank you, Mr. Chairman. I am George Bissell, Chairman and Chief Executive Officer of the Keystone Group of Mutual Funds, which manages mutual funds assets of approximately $10 billion.

I started my career as an investment analyst and am a past Chairman of the Financial Analysts Federation. I have also been Chairman of the Board of Governors of the Investment Company Institute, the national trade association of the investment company industry. I currently serve on the Institute's Board and Executive Committee.

Serving also as Chairman of the Institute's Task Force on Market Reform has provided me with a broad view of what happened on October 19 and the days that followed.

I appreciate the opportunity to testify before this subcommittee on the Market Reform Act of 1989.

In the interest of time, I would like to give a brief summary of these views on the Market Reform Act. I have prepared written testimony that addresses each of the provisions of the bill in greater detail.

It is my understanding that the provisions contained in the Market Reform Act are in large part a response to the October 1987 market break. That event had a powerful and lingering effect on the appetite of American investors for equity investments. Many investors have been left with the perception that the markets do not operate fairly and are not regulated in the interest of the average investor.

Departing slightly from my written testimony, I am pleased to report that by and large mutual fund shareholders did not react to the events of October 19 by engaging in large-scale redemptions. Industry studies indicate that less than 2 percent of equity fund assets were redeemed on October 19. Significantly lower daily levels of redemptions and exchanges occurred during the remainder of that week.

Those shareholders who did not redeem their shares during this time had their confidence in mutual funds rewarded. For the 12-month period ending December 31, 1987, the average total return on equity mutual funds actually showed an increase of 2.3 percent, even after taking into account the turmoil of October, and for the 2-year period ending December 1988 the total return showed an increase of 18.5 percent.

Not only am I pleased with this solid performance of the industry, I am also hopeful that this experience has demonstrated that despite the recent explosion of short-term strategies, such as program trading and various methods of arbitrage, the mutual fund industry continues to serve the long-term investor very well.

I also want to point out that the mutual fund industry may have played a very important role in reducing the pressures on October

19th. While, as might be expected, there was a great deal of variation among individual funds, equity funds collectively were able to meet a substantial portion of their redemption requests out of their cash positions, which reduced the need to sell securities. Industry surveys show that the industry was able to absorb approximately $1.5 billion in selling pressure on October 19 in this manner.

Although mutual funds were able to function satisfactorily under extreme market conditions and meet their obligations to investors, the industry has not turned its back on the structural problems made apparent by the extreme stress to which the markets were subjected.

As important users of the markets and as representatives of millions of individual shareholders, the Keystone Group and the industry have a keen interest in improving the functioning of the nation's financial markets.

Restoration of public confidence in large part depends on reforms which will increase the efficiency and stability of the markets in which we invest our shareholders' money.

With this in mind, I would like to address the provisions of the Market Reform Act. I would like to begin with section 3, concerning large trader reporting. It is of paramount importance both to improve the quality of data related to trading and to enhance the flow of this information across markets. Therefore, the idea of increased reporting of transactions in equity securities and related products is generally a good one.

However, I would urge inclusion of a provision similar to that contained in section 13(f) of the Securities Exchange Act which would make information contained in reports under this section generally available to the public. The Commission should of course be authorized to delay or prevent public disclosure if it determines it is necessary or appropriate in the public interest or for the protection of investors.

I also suggest that a provision directing the Commission to adopt rules to eliminate duplicative reporting be added to the Act, as some of the reports called for could overlap those already required under section 13(f).

Turning to section 5, concerning coordinated clearing, I believe that this provision is essential. In light of the linkages among our various financial markets, it is important that the clearing systems appertaining to each related market are coordinated.

I wish to emphasize, however, that while the coordinated clearing provisions contained in this bill are a welcome step, they appear only to be a first step. The need for greater coordination among markets is unfortunately not limited to clearing and settlement. Other issues need to be addressed.

For example, it should be an important regulatory goal that the essential information as to every trade be recorded in permanent form at the time of execution. This would reduce substantially the error rate in active markets and provide a powerful tool for market surveillance.

The SEC should also engage in rulemaking, where appropriate, in conjunction with the CFTC, to establish to the extent feasible true intermarket settlement. Ideally, this would encompass netting of positions across markets, clear guidelines for the extension of equity-collateralized loans during extreme market conditions, and conformity in the time for settling transactions.

I would now like to address briefly two other sections of the Act. I generally support section 2, which would grant the SEC emergency authority both to institute trading halts and to take certain short-term actions without compliance with the ordinary notice and comment procedures.

With respect to trading halts, I believe that they should be instituted only after careful consideration of all of the surrounding circumstances by the appropriate supervisory body, and not by reference to an arbitrary formula. I also believe that in order to be effective trading halts, if needed, should not be confined to the securities markets but should apply to all equity-related futures products.

I view the more general grant of emergency rulemaking authority contained in this section as a clarification, since the SEC, along with other Federal agencies, is already permitted under the Administrative Procedure Act to dispense with full procedural requirements under appropriate circumstances.

Additionally, I would like to request that the bill clarify that an emergency under the Market Reform Act would also constitute an emergency for purposes of section 22(e) of the Investment Company Act. Mutual funds, pursuant to section 22(e), may suspend redemptions during emergencies. However, it has never been clear when an emergency under 22(e) exists.

With respect to the section on holding company risk assessments, while I support the goal of enabling the Commission to monitor effectively the financial condition of reporting brokers and dealers, I am somewhat uneasy over the broad scope of section 4. I wonder whether there is a less expansive means of accomplishing the same goal, such as placing increased emphasis on the broker/dealer capitalization itself.

I would like to take this opportunity to share briefly the findings of the investment company industry's Task Force on Market Reform, which was formed in early 1988 by the Investment Company Institute for the purpose of considering various legislative and regulatory proposals for market reform.

The task force is still at work and intends to explore certain issues in greater depth at a meeting next week. As Chairman of this task force, I naturally endorse and espouse its recommendations, and I hope that its work can be of assistance to this subcommittee, other agencies of government and the exchanges.

The task force's preliminary conclusions support the view that the increased links between the markets for equities, options, and futures have resulted in the emergence of what is in many respects a single market. In this regard, the task force largely endorsed the main findings of the January 1988 report of the Presidential Task Force, the Brady Commission, and in general is in agreement with its five principal policy recommendations.

These are:

First, there is a need for a single body with authority to coordinate regulations pertaining to all equity-related markets, which are currently subject to different regulators.

Second, the clearing and settlement systems of the various markets should be made more uniform.

Third, the intermarket oversight body should have authority to halt trading in extreme situations.

Fourth, minimum margin requirements should be set to meet prudent or prudential standards.

Fifth, the flow of information between markets must be enhanced.

The task force believes that enactment of such policy recommendations is necessary to ensure the smooth functioning of the nation's financial markets.

I would like to conclude by stating that the Keystone Group and the investment company industry remains vitally concerned with the maintenance of securities markets that are structurally sound and operating efficiently. Public participation in the marketplace by mutual fund shareholders and others depends on the existence of well-functioning and well-regulated markets in which the public has confidence.

I believe that the industry is therefore generally supportive of the reforms recommended in S. 648.

I will be happy to answer any questions that you may have.

[The complete prepared statement of George S. Bissell follows:]

WRITTEN STATEMENT OF
GEORGE S. BISSELL
CHAIRMAN AND CEO
KEYSTONE GROUP INC.
BOSTON, MASSACHUSETTS

BEFORE THE
SECURITIES SUBCOMMITTEE OF THE
SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

ON S. 648, "THE MARKET REFORM ACT OF 1989"

MAY 18, 1989

SUMMARY AND INDEX

I. S. 648, "The Market Reform Act of 1989" 1

1. Large Trader Reporting 2

It is of paramont importance both to improve the quality of data related to trading and to enhance the flow of this information across markets. Public dissemination of certain of the trading data derived from the reports is also important, provided appropriate consideration is given to needs for confidentiality. The SEC should adopt rules under this section to eliminate duplicative reporting.

2. Coordinated Clearing 5

This provision is essential in light of the various financial markets. However, it is only a first step. Information as to every trade should be recorded in permanent form at the time of execution. The SEC, in conjunction with the CFTC, should adopt rules to establish intermarket settlement. The SEC should not be precluded from recommending establishment of a single, unified clearing agency.

3. Emergency Authority 8

Trading halts should be imposed after careful consideration by the proper authorities and not by reference to an arbitrary formula. In addition, trading halts should not be confined to securities markets, but should extend to markets for all equity-related products. The general grant of emergency rulemaking authority appears to be simply a clarification. "Emergencies" under this Act should constitute "emergencies" under the Investment Company Act for purposes of permitting suspension of redemptions.

4. Holding Company Risk Assessments 10

A more narrowly tailored provision or an increased emphasis upon capitalization would be preferable to the broad scope of this section. Banks should only be exempt to the extent similar reports are actually filed and available to the SEC. A similar exemption should be adopted for investment advisers and other entities that file reports with the SEC.

II. The Investment Company Industry's Market Reform Task Force 12

A. Background 12

B. Recommendations 13

1. There is a need for a single body with authority to coordinate regulations pertaining to all equity-related products, which currently are subject to different primary regulators.

2. The clearing and settlement systems and procedures of the various markets should be made uniform or, at least, fully compatible.

3. The inter-market oversight body should be granted authority to halt trading on the markets in extreme cases.

4. Minimum margin requirements should be set to meet prudential standards with appropriate adjustments in light of the varying prudential considerations of differing securities.

5. The flow of information between markets must be enhanced.

III. Conclusion 16

IV. Appendix - Response to Additional Questions

I am George S. Bissell, Chairman and Chief Executive Officer of the Keystone Group Inc. which manages mutual fund assets of approximately $10 billion. I started my career as an investment analyst and am a past Chairman of the Financial Analysts Federation. I have been Chairman and CEO of the Keystone Group Inc. since coming to that organization in 1978. I have also been Chairman of the Board of Governors of the Investment Company Institute, the national association of the investment company industry, and I currently serve on its Board and Executive Committee. Serving also as Chairman of the Institute's Task Force on Market Reform has provided me with a broad view of what happened on October 19 and the days that followed. I appreciate the opportunity to testify before this Committee on S. 648, the "Market Reform Act of 1989."

I. S. 648, the "Market Reform Act of 1989"

It is my understanding that the provisions contained in S. 648 are, in large part, a response to the market break of October 1987. That event had a powerful and lingering effect on the appetite of investors for equity investments. Many American investors have been left with the perception that the markets do not operate fairly and are not regulated in the interest of the average investor. Although mutual funds were able to function satisfactorily under extreme market conditions, the industry has not turned its back on the structural problems made apparent by the extreme stress to which the markets were subjected.

As important users of the markets, and as representatives of millions of individual shareholders, the Keystone Group and the investment company industry has a keen interest in improving the functioning of the nation's financial markets. Restoration of public confidence in large part depends on reforms which will increase the efficiency and stability of the markets in which we invest our shareholders' money.

With this in mind, I would like to address the provisions of the "Market Reform Act of 1989." You have asked for comments on four specific sections of S. 648:

1. Large Trader Reporting;
2. Coordinated Clearing;
3. Emergency Authority; and
4. Holding Company Risk Assessments.

1. Large Trader Reporting

Section 3 of S. 648 would authorize the SEC to adopt rules that would require the reporting of certain transactions to the SEC (or to a self-regulatory organization designated by the SEC). The reporting obligations would encompass transactions in publicly-traded equity securities and options, futures contracts with respect to such securities and options on futures. Although the bill would define any security or option that is traded on a national securities exchange or quoted in an automated inter-dealer quotation system as "publicly traded", I understand that the Commission would be authorized to require reporting of "off-exchange" transactions of those securities as well.

It is of paramount importance both to improve the quality of data related to trading and to enhance the flow of this information across markets. Therefore, the idea of increased reporting of transactions in equity securities and related products is generally a good one. I believe in the principle of transparency. However, the provisions of Section 3, as currently drafted, may be both underinclusive and overinclusive.

They may be underinclusive in that it is unclear what data will be made publicly available, since the information will be exempt from the Freedom of Information Act. I understand that the Commission intends these reports to be used for purposes of surveillance, enforcement and other regulatory purposes and in this regard the Commission's intentions are meritorious. However, after legitimate concerns for privacy are satisfied, the public dissemination of certain of the trading data derived from these reports is likewise important. The increased trading in equity derivative products, as well as the greater possibilities to trade outside an exchange or automated quotation system, make it more difficult for investors to be fully informed of the markets in which they trade and to base their investment decisions on such information. Therefore, I suggest the inclusion of a provision, similar to that contained in Section

13(f) of the Securities Exchange Act, that would make information contained in reports under this section generally available to the public.

It is important to note that Section 13(f) permits the Commission to delay or prevent public disclosure of information filed pursuant thereto if it determines it to be necessary or appropriate, in the public interest or for the protection of investors. Thus, for example, the Commission would be authorized to make price and volume data derived from those reports publicly available on a prompt basis, while keeping the identity of the parties confidential, perhaps for a certain specified time period. Such an approach would balance the goals of greater market information with the need for confidentiality during the pendency of certain transactions. Moreover, any rule adopted under this provision should require brokers who execute public orders to report principal trades separately.

On the other hand, Section 3 may be overinclusive in that some of the data may already be subject to reporting requirements under the Securities Exchange Act. Pursuant to Section 13(f) of that Act, and the rules thereunder, institutional investment managers must report holdings of equity securities and options under management and the Commission is authorized to prescribe reporting of certain transactions. Similarly, institutional investors must report 5% or greater holdings of voting securities under Sections 13(d) and 13(g). The addition of a provision to

S. 648 mandating the adoption of rules to eliminate duplicative reporting is necessary. Similarly, the Commission, pursuant to the rulemaking authority granted in paragraph (3) of this Section, should adopt rules for aggregating accounts and transactions that are consistent with the other reporting obligations I mentioned. This will help to minimize burdens on reporting entities and facilitate compliance.

2. Coordinated Clearing

Section 5 of the Market Reform Act would direct the Securities and Exchange Commission to facilitate the establishment of "linked, coordinated or centralized" clearing facilities for securities, options on securities, futures contracts, options on futures, and commodities options. I note that the SEC is directed to consult with the CFTC and the Federal Reserve Board on this matter.

This provision of the bill is essential. In light of the linkages among the various financial markets, it is important for the clearing systems appertaining to each related market to be coordinated. On the operational side, the appropriate regulatory agencies should encourage the adoption by exchanges and clearing houses of compatible communication and data processing technology and common procedures for entry and capture of trades. Furthermore, exchanges and clearing houses should be urged to adopt common criteria, practices and deadlines for matching, clearing and final registration of trades.

On the financial side, homogeneity of practices is no less important. It is unsettling, for example, that deadlines for bank confirmation of payment of margin or final settlement are quite diverse across exchanges and clearing houses. Additionally the ability of clearing organizations to request payment of intra-day variation margins, especially in volatile markets, should be uniform. As a related matter, capitalization and credit line capacity of clearing organizations should be subject to uniform regulatory standards.

I wish to emphasize, however, that while the coordinated clearing provisions contained in this bill are a welcome step, they are _only_ a first step. The need for greater coordination among the markets is unfortunately not limited to clearing and settlement. Other issues, such as the appropriate capitalization of exchange specialists and the responsibilities of exchange members who execute orders for the public and for themselves still remain open. These need to be addressed.

For a host of compelling reasons, ranging from operational efficiency to the integrity of the markets, it should be an important regulatory goal that the essential information as to every trade be recorded in permanent form at the time of execution. The "locked in" trade would substantially reduce the error rate in active markets, as well as provide a powerful tool for market surveillance. While the New York Stock Exchange and other exchanges have made substantial progress in this area, more remains to be done, particularly by the futures exchanges.

I would also stress that, in performing its "facilitation" function under the Market Reform Act, the SEC should actively engage in rulemaking (where appropriate, in conjunction with the CFTC) in order to establish, to the extent feasible, true intermarket settlement. Ideally, this would encompass netting of positions across markets, clear guidelines for the extension of equity-collateralized loans during extreme market conditions and conformity in the time for settling transactions (which should be next-day, as is currently the case on futures exchanges).

To follow up on this point, I must say that I am somewhat apprehensive about the language in the Act that directs the Commission, in undertaking its duties thereunder, to have "due regard" not only for the protection of investors, safeguarding of securities and competition among brokers and dealers, but also for fair competition among clearing agencies. It should be made clear that this language should not be construed to prevent the Commission from ever concluding that a single, unified clearing agency would best serve the market as a whole or from ever making appropriate recommendations in this regard to the Congress. Of course, the SEC may not come to this conclusion. But I hope that the language in the bill would not rule out even the possibility of such a conclusion.

3. Emergency Authority

Section 2 of the Market Reform Act would grant the SEC essentially two types of emergency authority -- one specific, the other more general.

First, the Commission would be able to suspend securities trading on any national securities exchange "or otherwise" for up to 24 hours. This could be extended for two additional 24 hour periods, with the President's consent. The President could also cancel any SEC action in this area.

I generally support this provision. Trading halts should be imposed only after a careful consideration of the surrounding circumstances by the appropriate supervisory body. Such an approach is far superior to one that mechanically applies an arbitrary formula.

However in keeping with my general theme of the interrelatedness of our markets, trading halts, if needed, should not be confined to the securities markets, but should also apply to markets for all equity-related products. Thus, the formal authorization of an ongoing "Gould Committee" to oversee intermarket matters and, specifically, to institute comprehensive trading halts in extreme situations, is preferable.

Failing that, within the parameters of S. 648, some formal provision under which the Commission, at or before the commencement of any trading halt, would be required to notify, at a minimum, the CFTC, the Treasury Department and the Federal Reserve Board is necessary. Practically speaking, I believe such notice would be followed by trading halts on the futures exchanges and in related markets.

In addition to trading halts, this provision of the Act would grant the SEC general emergency rulemaking authority enabling it to take certain short-term actions without compliance with the notice and comment provisions of the Administrative Procedure Act.

It seems that the purpose of this provision is one of clarification. The Commission, along with other federal agencies, is already permitted to dispense with full procedural requirements under appropriate circumstances. For example, Section 553 of the Administrative Procedure Act allows waiver of notice provisions upon a finding that it would be "impracticable, unnecessary or contrary to public interest". Additionally, it should be made clear that this emergency power applies only to areas over which the Commission currently has rulemaking authority and does not give the Commission carte blanche to enact rules in areas over which it does not have such authority.

Finally, I would like to make one comment that pertains especially to mutual funds. Mutual funds currently may suspend redemptions under Section 22(e) of the Investment Company Act only (1) when trading is restricted on the New York Stock Exchange or the Exchange is closed, (2) when an emergency exists which makes it impracticable for a fund to dispose of or value its securities, or (3) otherwise by Commission order. Unfortunately, it has never been clear when an "emergency" within the meaning of Section 22(e) exists, and mutual funds can be placed in a difficult situation in cases of extreme market conditions. Therefore clarification that an "emergency" under the Market Reform Act would also constitute an "emergency" for purposes of Section 22(e) is necessary.

4. Holding Company Risk Assessments

Section 4 of the Market Reform Act would broaden the Commission's authority with respect to financial reporting by brokers and dealers by permitting the Commission to require reports of affiliated companies of such brokers and dealers if they have the potential to have a material impact on the broker's or dealer's financial condition.

I understand the Commission's purpose in recommending this provision, namely, to enable it to monitor effectively the financial condition of reporting brokers and dealers. However, the provision's broad scope is disturbing. Section 4 of the Market Reform Act could have the effect of dramatically increasing the scope of the Commission's jurisdiction over unregulated companies, which are not themselves involved in the securities business. Further, if the staff of the Commission is inundated with a flood of financial statements from numerous additional companies, its supervisory abilities over brokers and dealers may actually be inhibited.

Therefore, it seems preferable for the Commission to adopt rules tailored to those types of circumstances upon which this proposal is based, i.e., actual instances in which the financial condition of a parent company or other affiliate of a broker-dealer adversely affects the condition of the broker-dealer (and the broker-dealer's financial reports do not reveal any potential problems). Another alternative would be to place increased emphasis upon the capitalization of broker-dealers, in order to provide them a margin of safety from unhealthy affiliated corporations.

Additionally there seems to be a lack of parallelism in the bill as it now stands. Banks and certain other regulated entities would be automatically exempted from the reporting provisions if similar records are "available" to a supervisory agency. I respectfully suggest that, to whatever extent the Commission adopts rules requiring affiliates to report to it under this Section, exceptions for other regulated entities should extend only to entities whose reports are actually filed with a supervisory agency (and are available to the Commission). Otherwise, the apparent justification for this exemption (that such reports would be duplicative) would be inapposite. Moreover, similar exemptions under this section should be made available to entities that already must file with the SEC, such as registered investment advisers that have custody of client securities.

II. The Investment Company Industry's Market Reform Task Force

A. Background

As a way of responding to the second question posed by the Committee:

> Do you believe S. 648 sufficiently addresses the problems revealed in the 1987 market crash? In view of regulatory and private sector initiatives undertaken since the crash, is the legislation, in part or whole, unnecessary? Are there other issues which should be addressed or other steps that should be taken to assure a sound market environment?

I would like to take this opportunity to share briefly the findings of the investment company industry's Task Force on Market Reform, which was formed in early 1988 by the Investment Company Institute* for the purpose of considering various legislative and regulatory proposals for market reform.

The Task Force is still at work and intends to explore certain issues in greater depth at a meeting next week. As

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* The Investment Company Institute is the national association of the American investment company industry. Its membership includes 2,870 open-end investment companies ("mutual funds"), 155 closed-end investment companies and 14 sponsors of unit investment trusts. Its open-end investment company members have assets of about $821 billion, accounting for approximately 90% of total industry assets, and have over 30 million shareholders.

Chairman of the Task Force, I naturally endorse and espouse its recommendations and I hope that its work can be of assistance to this Committee, other agencies of government and the exchanges.

B. Recommendations

The Task Force's preliminary conclusions support the view that the increased links between the markets for equities, options and futures have resulted in the emergence of what is in many respects a "single market". In this regard, the Task Force largely endorsed the main findings of the January 1988 Report of the Presidential Task Force on Market Mechanisms (the "Brady Commission") and is in general agreement with its five principal policy recommendations. The Task Force believes that enactment of each policy recommendation is necessary to insure the smooth functioning of the nation's financial markets.

1. First, there is a need for a single body with authority to coordinate regulations pertaining to all equity-related markets, which currently are subject to different primary regulators. One model for such an oversight body is the Working Group on Financial Markets, which is also known as the "Gould Committee". Hopefully, such an inter-agency body could serve two primary functions -- to work towards greater regulatory consistency and to authorize the creation of an executive-level crisis management team to deal with market emergencies.

2. Second, the clearing and settlement systems and procedures of the various markets should be made uniform or, at

least, fully compatible, in an effort to minimize the duration of inter-market credit exposures. As I mentioned earlier, Section 5 of S. 648 is an important step towards this goal, but only a first step. Two additional steps would be to require netting of trading positions across markets and ultimately to require next-day settlement in equity transactions, as is currently the case in the futures markets. Such uniformity would also help to render information about individual market participants' overall positions and financial exposures at any point in time more accurate and reliable.

3. Third, the inter-market oversight body should be granted authority to halt trading on the markets in extreme cases, such as those of October 19, 1987. Such trading halts should apply to all markets, not simply the stock exchanges. In addition, the Task Force has strong reservations against preset inflexible "circuit breakers" that would shut down trading after a pre-determined price-change limit is reached. Instead, the body with responsibility over market halts should have the flexibility to impose trading halts of different durations depending on the circumstances. Such circumstances might include the existence of extreme order imbalances or disruptions in information flows, which are more likely than large price changes *per se* to result in systems "gridlock" and thus market breakdowns.

4. Fourth, the Task Force recognizes that margin requirements have historically played a dual role. Margin requirements

provide the credit-extending party with a reasonable protection against a sharp decline in the value of the collateralized security. This prudential function of margins would make their levels dependent on the financial characteristics of the collateralized security, in particular on its expected price volatility. There is no controversy about the necessity of setting margin requirements at levels which comfortably assure the completion of a transaction. The second, more controversial, function of margins has been to regulate permissible leverage in order to dampen speculative excesses. Whether margin regulation is effective to achieve this goal without unduly interfering with market efficiency is questionable.

Therefore minimum margin requirements should be set to meet prudential standards with appropriate adjustments in light of the varying risk characteristics of differing securities. If as suggested, the working group is formalized into a permanent body, it might serve as the final arbiter of margin requirements for all markets under its jurisdiction under a broad public policy standard. Until that time however, the touchstone for margin regulation should be financial prudence. In addition, cross-margining across markets should be permitted only where it is clear that prudential considerations are not being compromised.

5. Finally, and perhaps most importantly, the flow of information between markets must be enhanced. Adoption of most of the other recommendations will be of little practical use

unless market participants, as well as regulators, have general access to trade-related data. For example, both netting of positions for settlement purposes and cross-margining depend on efficient and timely public dissemination of information across markets.

III. Conclusion

I and other members of the investment company industry remain vitally concerned with the maintenance of securities markets that are structurally sound and operate efficiently. Public participation in the marketplace, by mutual fund shareholders and others, depends on the existence of well-functioning and well regulated markets in which the public has confidence. I, therefore, am generally supportive of the reforms that have been recommended in S. 648. I hope that Congress will move expeditiously to enact reform proposals into law, while giving consideration to the suggestions for improvement that I have presented here today. The Subcommittee is to be commended for continuing its work towards greater rationalization and integration of our nation's financial markets. The investment company industry will continue to offer its assistance to this end. Attached as an appendix are the answers to additional questions posed by the Subcommittee.

Appendix

1. On March 17, 1989, we introduced, at the request of the Securities and Exchange Commission, S. 648, the Market Reform Act of 1989. We would appreciate your comments on the bill's four specific sections: SEC Emergency Authority and Trading Halts, Large Trader Reporting, Risk Assessment for Holding Company Systems, and Coordinated Clearing and Settlement.

2. Do you believe S. 648 sufficiently addresses the problems revealed in the 1987 market crash? In view of regulatory and private sector initiatives undertaken since the crash, is the legislation, in part or whole, unnecessary? Are there other issues which should be addressed or other steps that should be taken to assure a sound market environment?

These questions have been addressed in my testimony.

3. The October 1987 market disturbance revealed some significant shortcomings in market mechanisms and operations. Do you feel that these problems and concerns have been sufficiently addressed? What do you see as future problems to which market regulators and the Congress should be attentive?

While neither I nor the Task Force has conducted an independent review of this issue, I am aware of some anecdotal evidence that surfaced in the deliberations of the industry Task Force that might be of interest to the Subcommittee.

During the market break, breakdowns in communications facilities made it difficult, and at times impossible, to transmit orders to brokers on the floor. Ironically, even orders to purchase shares of stock were often unable to be executed. I can only speculate over how this failure in communications may have exacerbated declines in market value.

On the basis of these reports, it is therefore recommended that the exchanges and their member firms work towards the development of more efficient and more dependable communications media between the trading desk and the floor. I understand that a good deal of work has been done to improve communication efficiency but neither I nor the Task Force is in a position to offer any independent evaluation of these improvements.

Another issue relating to market operations is the capitalization of specialist firms. The reports of both the Brady Commission and the GAO noted that the issue of specialist capitalization might warrant further attention. It is my understanding that the level of capitalization has not kept pace with overall trading volume and the institutional share of stock ownership.

I note that the exchanges, in particular the New York Stock Exchange, are taking steps to increase the required capital of specialist firms. This is an area that should be carefully monitored in the future.

4. In the last Congress, legislation entitled "The Intermarket Coordination Act of 1988," S. 2256, was sponsored by Senator Proxmire and a number of our colleagues, but it did not become law. The legislation reflected substantial concern on the part of its sponsors that, while the markets were "linked" through trading practices and strategies, there was insufficient coordination among the regulators charged with overseeing individual markets. Earlier, in January 1988, the Presidential Task Force on Market Mechanisms recommended that "one agency should coordinate regulatory issues which have an impact across the related market segments and throughout the financial system," and suggested that the Federal Reserve fill that role. In your view, have these concerns been addressed? Has there been sufficient cooperation and coordination among the regulators over the past eighteen months? In addition, please discuss the cooperative efforts among exchanges and other self-regulatory organizations.

As I indicated in my testimony, the mutual fund industry strongly favors the formal establishment of an interagency body with the authority to implement coordination and cooperation among the various regulators of our financial markets.

The preferred model for such an oversight body is the Gould Committee. I understand that this group has continued to meet on an informal basis. However, such an ad hoc arrangement, without legislative authorization and guidelines, may not prove sufficient to ensure regulatory consistency and, most importantly, to take any and all necessary actions during market emergencies.

5. Section 5(b) of S. 2256 contained an "International Initiative," authored by Senator Dodd, which would have directed the Intermarket Coordination Committee created by the legislation to initiate discussions with regulators of foreign financial institutions and markets for the purpose of enhancing the exchange of information and coordinating regulatory activities. In a speech on December 28, 1988, Federal Reserve Chairman Greenspan observed: "More needs to be done, especially to increase the consistency of rules and procedures for markets located in different countries. Differences in market design and regulatory structure make the job difficult. But as integration of international markets increases---and that is inevitable--broader coordination will become all the more essential." What are your views in this area? Do you believe that the level of international regulatory coordination is adequate?

The mutual fund industry has followed with interest the developments towards increased internationalization of the securities markets. For example, in the fall of this year, the member nations of the European Economic Community will implement the so-called UCITS directive. This will enable mutual funds to be cross-marketed among the EC countries.

Representatives of the American mutual fund industry through the Investment Company Institute have been meeting, on an on-going basis, with representatives from European investment companies and their trade associations. The purpose of these meetings has been to explore the possibility of using the UCITS directive as a basis for cross-marketing arrangements for investment companies between the United States and the EC.

We have continued to report to the SEC on our discussions with the Europeans and we hope to make recommendations to the

Commission on regulation of cross-marketing of investment company shares in the near future. Of course, any effective implementation of a program to allow shares of investment companies to be traded internationally will require cooperation and coordination among U.S. and foreign regulatory agencies. We therefore support steps that would formalize the exchange of information between the regulators of financial institutions in various countries in order to make this regulatory coordination possible.

6. In March of 1989, the Group of Thirty issued a report entitled, Clearance and Settlement in the World's Securities Markets, which outlined deficiencies in clearance and settlement as well as offered nine recommendations to alleviate these risks. Do you agree with the recommendations of the report and, if so what steps need to be taken in order to move the world markets toward a system of coordinated clearance and settlement? Are there first steps that need to be taken to improve domestic clearance and settlement?

Although I am aware of the report of the Group of Thirty, I have not yet studied it. Representatives of the Investment Company Institute attended the May 15 conference on the Report. The Institute's review is incomplete, but when ready, I will ask the staff to make its findings available to the Subcommittee.

7. What are the greatest challenges confronting the U.S. securities markets and the capital formation process in the next decade? What steps must be taken now to meet those challenges?

The key to accelerating the rate of capital formation is a substantial increase in the nation's savings rate. Reducing federal demand for credit and tax changes targeted at capital formation and improving the rate of personal savings are at least as important as measures aimed at improving the functions of the securities markets.

Turning to the role of securities markets in the capital formation process, they must continue to perform the crucial function of allocating capital among its users. The main challenges in this respect are the preservation of our securities markets' ability to innovate and the enhancement of their openness, integrity and efficiency.

I think that S.648 is a good beginning in meeting these challenges.

Innovation has traditionally played an important role in the success and improved efficiency of the U.S. capital markets. In the 1980s, Wall Street has been innovative in pioneering new investment products and techniques which have resulted in a greater ability to transfer risk, an enriched menu of investment opportunities and greater market liquidity.

Improved technology and financial innovations, such as derivative instruments and mortgage-backed securities, have contributed to better access to the market for investors and issuers as well as to improved efficiency of the capital allocation process. This suggests that a successful regulatory policy should encourage innovation but at the same time develop appropriate investor protections and maintain a fair competitive balance.

Market openness is of particular importance in view of the rapidly progressing globalization of the securities markets. The integration of American capital markets within the world markets represents a major challenge and opportunity. Of the leading industrial nations, the U.S. capital formation process distinguishes itself for its comparatively easy access and high efficiency. This would appear to represent a competitive advantage for the U.S. However, recent attempts by foreign countries, most notably by Japan and the U.K., to "catch up" with us through liberalization of rules governing their securities markets pose a new competitive challenge. If doing business in our securities markets becomes too costly and burdensome, trading activity will inevitably shift to locations less encumbered by regulations. Given the high mobility of international capital flows, the dominant capital markets of the future will be those that can be most efficiently, easily and cheaply accessed by investors and issuers.

Turning to the area of market efficiency, the challenge consists of retaining the U.S. position as the lowest cost producer among leading world suppliers of capital market services.

Free market competition has reduced transaction costs, resulting in higher volumes of trading and improved liquidity. While those trends were clearly in place prior to October of 1987, recent trends have not been so encouraging. High intra-day market volatility stemming from short term trading techniques of some leading financial institutions has caused some classes of investors to abandon the equity markets. The short term effect has been to reduce market liquidity, raise transaction costs and lead other investors to adopt strategies to reduce turnover and portfolio costs. As a result, brokerage industry profits are under pressure, liquidity conditions deteriorate and the capital allocation function of the market is impaired.

Another undesirable side effect of the perceived rise in market volatility is to increase the risk premium that investors implicitly require on financial assets, such as equities, relative to less risky investment alternatives. The higher risk premium translates directly into higher cost and reduced availability of capital, particularly for IPOs.

In addition, the short term trading strategies that are referred to above are directly contributing to increasing conflicts of interest between brokers and their customers. Public policy cannot guarantee that equity market investing is safe at all times for the small or institutional investor. Yet it does appear that public policy should address the propriety of trading strategies that reduce access to the capital markets by longer term oriented investors.

The final challenge relates to the critical importance of rebuilding public confidence in the integrity of our securities markets. We believe the retail investor has become bewildered by extreme market gyrations and repulsed by many reported instances of illegal or unethical conduct exhibited by securities professionals. Regarding violations of securities laws, the answer should not be a barrage of more stringent laws but a more vigorous enforcement of existing statutes. In this connection, it is clear that we need to give the regulatory agencies, the SEC in particular, the necessary resources to carry out its rule-making and enforcement responsibilities -- a subject which I address separately below.

In general, however, I strongly believe that transparency and disclosure are the key to keeping market participants honest and honorable. The SEC should, in my judgement, require more complete disclosure by financial intermediaries of information pertaining to pricing, commissions and investment performance.

Without public trust in securities markets, other reforms will count for precious little.

8. In your judgement, do the SEC and CFTC have sufficient resources and authority to deal with another market disturbance comparable to what took place on October 19, 1987? If not, what additional resources and authority is needed?

The mutual fund industry remains deeply concerned that the level of resources available to the SEC has not kept pace with the enormous increases in trading volume and the number of registered broker-dealers, investment advisers and investment companies over the past 25 years, as well as the greatly increased complexities of the securities markets. Attached is a copy of a letter from the President of the Investment Company Institute to Chairman Dodd. This letter, which was also sent to all other Chairmen of relevant Committees and Subcommittees, sets forth our concerns in this area and requests that the level of funding for the SEC be substantially increased. Unless this is done, we fear that the SEC will not only be unable to deal effectively with another major market disturbance, but also will lack the resources to contend with other issues, such as internationalization and enforcement.

Senator DODD. Thank you. I must say that both of you have made excellent suggestions as well. We heard some of it in the earlier discussion. Maybe we should have had you on first so you could be taking credit for some of these ideas, which you really richly deserve.

Let me run through some questions for you. I may not get to all of them. I would like to. You have been very patient already with busy schedules of your own.

Mr. Lane, I want to turn to your comments, if I could, page 7 and 8 of your prepared testimony. You say that S. 648 alone—and I quote you here—"does not sufficiently address the causes of the crash. We believe that three major reforms are still needed—unified regulation of inter-related markets, unified margin requirements for all equity and equity-related products, and clear standards on frontrunning."

I wonder if I could turn to one or two of those and engage you and Mr. Bissell in a bit of discussion. With respect to the unified regulation of inter-related markets, I wonder if you might explain why you believe that the lack of unified regulations was the cause of the crash. Then, Mr. Bissell, I would like you to comment on whether or not you agree with Mr. Lane and, if so, maybe there would be some other reasons and, if not, why you don't agree with him.

Mr. LANE. We certainly believe that the markets are inter-related and what happened on October 19 and 20, specifically, was they disassociated themselves from each other. Because the markets, when they talk to each other, the lack of information, you ended up with a chaotic kind of situation.

We think communication and inter-relationship are required, much better cooperation and much better assistance between the markets, in order to avoid and make sure that we don't go through another October 19th.

Senator DODD. Let me quickly ask, how would you address that problem today? In other words, what kind of regulatory structure would you support? Do you believe that the present level of coordination among the regulators and some of the regulatory organizations is not adequate, or is it adequate in light of what has happened since then?

Mr. LANE. We originally had taken the position that we wanted common regulation by the SEC on all equity and equity-related products. However, I am pleased to say that the cooperation between the CFTC and the SEC has been such that we are basically satisfied with what has been accomplished.

On the common clearance side there's very little been accomplished. That is still an open book.

Senator DODD. Mr. Bissell, do you want to comment?

Mr. BISSELL. Well, it seems to me simply that what happened on October 19 was that there were too many people who wanted to get through the door at the same time. The door was not big enough to handle that demand. Since that time a substantial amount of work has been undertaken by the exchanges and the derivative markets to improve the ability to handle those flows.

The causes of the flows are many-faceted, and I expect that the next time they will also be many-faceted, but basically all it amounted to was that there were a lot of people who wanted to sell all at the same time.

One of the problems that our organization ran into during this time, particularly on October 19th, was a breakdown in communications. So we were not able to assess what the market was really doing. As a result, we were unable to even contemplate the possibility of putting in purchase recommendations in a market where we were uncertain as to what was really going on.

On October 19 we actually had transactions which amounted to only $8 million, and that was at a time when we were managing about $2.5 billion in equities. So in effect we did almost nothing.

So, we are talking about how do we improve the communications. How do we have more disclosure of information for those who are interested in taking on securities at a particular level who are there and willing to step in and help out?

That is why we point to our recommendation that there needs to be a single body that overlooks the single member. Our preference for such a body is the Working Group on Financial Markets but whether or not the Secretary of the Treasury is included is your call, Mr. Chairman. Basically we think that there needs to be supervisory linkage.

I think, also, that we have strong views that participants in either market should not be permitted to destroy the fabric of the marketplace by the activities that they are undertaking. That is why the circuit breaker concept is so important, not only for single securities but for the markets as a whole. Circuit breakers can be instituted briefly, in order to expose positions and to permit a better understanding of what really is going on in the market, particularly during periods of imbalance and to permit reentry into the market as quickly as possible. We want as many participants as possible trading as narrowly and efficiently as possible so that volatility is reduced.

But clearly you have to have the rules and you have to have the oversight so they don't break the fabric of the system.

Senator **Dodd**. You are in a sense suggesting formalization, maybe legal status if you will?

Mr. **Bissell**. I am. It seems to me that having a predetermined circuit breaker exacerbates a market break. People can play the game until they see prices approaching a predetermined circuit breaker and indeed make decisions based on that approach. Rather, it is in my view, thinking of those that are involved in creating liquidity, that participants in the market should be aware of the fact that there are many facts in the marketplace that this one body will consider it there is to be a trading halt. Therefore, such flexibility will discourage playing the market against a predetermined circuit breaker.

It is that broad supervisory overview in my view, that will discipline behavior in the marketplace.

Senator **Dodd**. Do you agree with that, Mr. Lane?

Mr. **Lane**. Basically, yes.

Senator **Dodd**. Let me ask you about the unified margin requirements in all equity or equity-related products. Again, you suggest that we ought to have that.

Your testimony suggests that this, again, was one of the causes of the crash. We heard some comment on this from the previous witnesses. I wonder if you might comment about that, the disparity that exists in these various markets. They are different—different requirements, different reasons why they attract capital.

In light of some of the comments made earlier, I wonder if you might comment on whether or not you really believe that we can legislate that effectively.

Mr. **Lane**. We have talked about uniform, not the same. I think Leo is statistically correct in what he said, and that is I really have not seen anybody state that one of the major problems of what happened on October 19th and 20th had anything to do with margins. We are talking about uniform. I think we have uniform restrictions and regulations and individual firms can change margin requirements upward, so we can control our own risk as opposed to depending upon an outside entity.

So I really don't think margin is one of the major things to focus on at this point.

Senator **Dodd**. Mr. Bissell.

Mr. **Bissell**. This is one of the issues that was debated most vehemently among our task force group.

As I understand it, there are two factors. One is that you can address the financial soundness of those that are participating, and there is a certain level of margin that is required for that, which I think is the way it should normally work.

Then there is the idea of the ability to command capital, the relative basis of margin levels the cash—that is the stock—market as opposed to the derivative or futures market. It seems to me that one has to accept the policy of raising margins for that reason as being one to throw sand, if you will, into the machinery in order to save the very fabric of the cash market itself.

In other words, the only reason, in my view, that raising margins would be appropriate would be if indeed the cash market is in jeopardy of becoming non-viable because it is cheaper for everyone to do business in the futures market because the margins are lower. You can't have that happen. So if the cash market is in jeopardy, or if it were determined to be in the public interest or necessary to restore the integrity of the marketplace for the small investor, then there might be a reason from those points of view to equalize margins.

Senator **Dodd**. Frontrunning was raised as well. Senator Riegle brought that issue up. You had talked about it in your testimony, Mr. Lane, and made some comment about it already.

I wonder if you might just comment on that, what the inadequacies are of the current system in regard to that practice.

Mr. **Lane**. The problem is we do not have a unified definition, and the problem of a unified definition, given all of the very clever people that are in our business, is that the definition really has to be broad enough, yet narrow enough so that everybody understands what the rules of the game are.

Broadly speaking, as far as I am concerned, frontrunning involves intent and knowledge, and we have wording around it. If confidence is one of the keys in our marketplace—and it obviously is and it is still shaken—a better definition or a definition of frontrunning is needed.

I think we have to provide for arbitrage and hedging as offsets. We have not really made a lot of progress, and that is one of the reasons why. There is a problem of confidence in the marketplace. A lot of work still has to be done here, and we would be pleased to help work with the group to come up with an appropriate definition.

Senator Dodd. That would be helpful.

Mr. Bissell, do you agree with that?

Mr. Bissell. I certainly do. I am outraged by frontrunning. In my view, you cannot compete with your customer. We deal on a verbal basis with those that are acting on our behalf, such as the Shearson organization. We place an order with them. It will be a block, and we will say "not held", which means that we are giving the broker discretion and they can work that block. There is trust and confidence that is involved in both directions on a minute-by-minute basis all day long.

So there just has to be that sense of confidence involved in our operating together.

The risks of the conflicts inherent in frontrunning are that you risk your customer relationships.

Senator Dodd. I couldn't agree more. I said earlier if we had any one word here "confidence" is the one.

This brings up my last questions. We have all heard about the small investor not coming back, whether or not this bespeaks some lack of confidence. We have seen the market rise to almost the level we were in 1987. It may not be the same volume, but nonetheless it seems to be a far more stable environment, and we see the mutual funds—I gather that there is more cash than you could maybe dream of, there is just not enough good buys around, which is, I guess, a deleterious position to be in.

But I would like to know if you could both comment on what that tells us about investor confidence in general. Are we seeing more investors flocking to mutual funds because they don't feel confident about entering the market as individuals? Is that a conclusion one could draw from all of this, or is that a wrong reading of the situation?

I don't care which order you go in. Mr. Lane?

Mr. Lane. I think that some of our investors have obviously decided that it is better to join them than fight them, and therefore that investing in mutual funds is a way to avoid the problem. But I think that really is a misstatement, in that the clients of ours that invest in the mutual funds are not investing in equity mutual funds. They are investing in money market funds, fixed income funds.

Our institutional clients and our retail clients are avoiding equity markets. That really hasn't changed. The markets have performed reasonably well, but the market is not satisfying one of the primary requirements of helping raise equity risk capital for corporate America, and that is totally lacking.

Senator Dodd. Mr. Bissell.

Mr. Bissell. I agree. I think whether you are buying individual securities or mutual funds you are, in effect, going to the same end, participating in ownership of America. So we are suffering, in my view, from the lack of confidence from individuals in either case. Perhaps it relates more to the marketplace itself than the risk of the investment.

In other words, the economy appears to be on a better footing, and the values of the marketplace appear to be better today than they were earlier, as has been commented on earlier today. Yet I think that there is a distrust that pervades the public mind today about whether they are being treated fairly in the marketplace.

So from the mutual fund industry point of view, I think it is very important for us to try to improve the integrity of the system, as we have been talking about this morning, and to have others realize that the system does work well and is trustworthy and therefore they can place their trust through this system to buy pieces of America.

Senator DODD. That sort of brings me to this last question. A number of my colleagues feel pretty strongly about it and they expressed their views in their opening comments this morning about getting the individual investor back into the market.

Is the individual investor vitally important for the soundness and safety of these markets or is concern about individual investors simply antiquated thinking? Institutional investors are here, and that isn't going to change. So, is all this talk about bringing back individual investors to the market like nostalgia for small family farms? It is a wonderful idea. It makes for a great campaign slogan during the year. But some would suggest that the reality of life is such that that just isn't what is going to happen, that institutional investment is really where things are going, and harping on individual investors to bring mom and pop into the markets is really sort of pie in the sky that we shouldn't belabor.

I am not drawing that conclusion. But I have heard the same speeches about the family farm, and God help you if you stand up and say that you are advocating the abolition of the family farm, but reality is such that we understand what is happening in the marketplace.

Mr. BISSELL. I think that as the world becomes more complicated there is a greater need for expert help by individual investors in meeting their investment objectives. I agree that in the face of such complexity, there is an increasing awareness that other people are in a better position than I, as a small investor, to handle my needs. As such, I think the institutions are fulfilling their responsibility by offering products to the small investor and acting on their behalf.

It is a trend that in my view makes sense and serves the public very well. I agree with you—the individual has less sense of confidence in view of the complexity of the marketplace and, it is my view that his lack of confidence is going to increase.

Senator DODD. Mr. Lane?

Mr. LANE. I think it is important to note that not only do individual investors lack confidence in the marketplace, but institutional investors lack confidence in the marketplace. The issue really is not just bringing back the individual investor. I think the issue truly is bringing back confidence in the marketplace which involves not only the individual investor, whether he invests individually or through a mutual fund, but bringing back confidence in general, which involves pension plans, mutual funds, and so on.

The function they perform, which is capital raising, is critical to the United States' long-term position in the world, and savings and investments are not being appropriately handled here when you see what is going on in Germany and Japan, and unless we correct what is going on they will knock our socks off.

Senator **Dodd**. We could be accused of setting a setup deal here. This leads beautifully into my last question, which is on the internationalization of markets.

On the 14th and 15th of June, we are going to have a hearing with the Chairman of the Federal Reserve Board, Mr. Greenspan, talking about the international securities markets.

Perhaps this is a question you would like to answer briefly here, and then you could give it some more thought and respond to it in writing. I would appreciate it if my colleagues were here on the committee.

Obviously, this whole question is what do you do in terms of regulating our markets here and to what extent we may jeopardize our competitive situation. I think every one of us—and I really feel very strongly that all of us on this committee are very nervous about we are either, one, not regulating sufficiently enough so that we create problems at home or we are going to over-regulate to such an extent that we make ourselves noncompetitive abroad, and how you walk that narrow path is a difficult question for us.

Maybe you could help me by telling me what sort of questions we ought to be asking. What sort of questions should I be asking the regulators? What things should I be asking them to do?

What would you be advocating that the Congress be talking about in this regard, things that we are missing here?

Some suggest we may end up with "Fortress Europe." I think the first area you are going to see consolidation of the European Community is in financial institutions. I think things like manufacturing, and so forth, will come, but that is down the road. We don't have to worry about that. The one area we are going to face a juggernaut competitively is in financial institutions, in my view. That is going to be the first real challenge, and it seems to me then to kind of wait and see what happens in 1992 is being rather naive because clearly we are going to face a major competitor in this arena.

So what sort of things do you think we ought to be doing, asking, getting people to focus their attention on, questions that ought to be raised so that we do walk that road. Confidence in our markets, and our ability to raise capital, depends upon our ability to have healthy capital markets, yet simultaneously make it possible so that we are an attractive market, not just because we are the United States, but also because our market structure is such that it is competitive.

That is a big question.

Mr. **Lane**. Just as the U.S. markets are inter-related and we talk about Chicago and New York coordinating, I think we should also focus on the fact that the world markets are coordinated, and we could argue until the cows come home about whether the crash started in Japan or it started in Great Britain or it started in the

United States and we keep chasing our tail on who is chasing who downward. While we did really have a major problem in the United States on October 19 and 20, and we can argue what caused that narrowly defined in the States. Obviously, it was a worldwide problem.

So I think coordination amongst the world exchanges is terribly important, and I think, going back to the goose analogy that was used earlier, we do have to be very concerned about the fact that money is fungible. We do trade around the world, and if the regulations are such that we are kept from doing business in one part of the world and the regulations allow it in others, that is where obviously business will flow.

The United States has the opportunity to continue to dominate the world of financial services, and shame on us if we lose that competitive edge.

Senator DODD. I agree with you on that. I don't know if it is Walter Heller who used the phrase "lowest common denominator." You end up changing your own regulatory scheme to match, the Japanese or the British or anyone else for that matter. But you have got to be careful about that.

Mr. LANE. I think the answer surely is yes. You have to avoid the lowest common denominator. I think the thing that gives me some encouragement is the fact that our major trading partners, those that we would be most concerned about as far as competing with, are as concerned about the marketplace as we. I think if we can get the various central banks and the various exchanges to continue to cooperate and coordinate we can have a much better worldwide marketplace.

Senator DODD. Thank you.

Mr. Bissell.

Mr. BISSELL. Thank you.

I think we are talking about establishing standards as a way of equalization rather than any way that would be more heavy-handed. I happen to want our system to remain the best there is. There is a competitive aspect that says I want our markets to be better so we can continue to attract investment dollars which are drawn to the American market because they are treated with more integrity.

I think the first thing to do is to continue what we are doing in our own right. Then cooperating with others and watching what they are doing is necessary in order to guard against the overcumbersomeness that might result.

Above all, we should be flexible in meeting whatever the challenges may be as we enter the international arena where we really are uncertain as to how much is too much and how much is not enough.

Senator DODD. That is a very good point. One of the reasons we attract capital here is that not only is it the greatest place on the face of this Earth to make an investment for a potential rate of return, but because it is a solid investment. That is something we don't often talk about. There is that great sense of confidence that your investment here—that the laws of this land will not change tomorrow on you, and I think we ought not to lose sight of that as we talk about a regulatory scheme.

This has been very helpful to me. Your comments about the legislation are extremely worthwhile. As was stated earlier, this is legislation requested by the SEC. Senator Heinz introduced it, and I introduced it on their behalf.

I think there are some very good aspects to it, but like both of you and others, I have my concerns about it in a couple of areas. I gather there are meetings ongoing between industry personnel and the SEC and our staff as well up here. I hope within the next several weeks we can come to some common ground here.

My goal would be to have legislation that would at least meet the major concerns of industry as well as the SRO's and the regulatory community, and I think we can do that. I think there is a lot of common ground that I have heard mentioned here today in this area, far more community of interest than diversity of interest, it seems to me, as I have listened to the testimony of all five of you.

So again on behalf of my colleagues of this subcommittee, I want to thank both of you for being as patient as you have been and waiting as long as you have to appear before us this afternoon. We will look forward to some of your responses on these other questions. If you have got some additional ideas on the internationalization question, it might be helpful for us to raise some of these questions.

Until further call of the Chair, the subcommittee is adjourned.

[Whereupon, at 1:25 p.m., the subcommittee was adjourned, subject to the call of the Chair.]

THE MARKET REFORM ACT OF 1989

THURSDAY, OCTOBER 26, 1989

U.S. SENATE, COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, JOINT HEARING WITH THE SUBCOMMITTEE ON SECURITIES,

Washington, DC.

The committee met at 10:10 a.m., in room SD-538 of the Dirksen Senate Office Building, Senator Christopher J. Dodd (presiding).

Present: Senators Dodd, Riegle, Garn, Heinz, Gramm, D'Amato, Mack, Sarbanes, Shelby, Dixon, Bond, Bryan, Graham, Wirth, Kassebaum, and Pressler.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. The Committee on Banking, Housing, and Urban Affairs will come to order.

Mr. Secretary, we welcome you here this morning for the purpose of considering S. 648, the Market Reform Act of 1989. I want to first of all thank my chairman, Senator Riegle, as well as Senator Garn. This is a matter under the jurisdiction of the Subcommittee on Securities, but obviously because of your presence here and the interest by the full committee as a whole, we will be meeting as such. I thank the Chairman for allowing me to chair the hearing this morning under the auspices of the subcommittee.

Let me welcome, of course, everyone who is here today, especially you, Mr. Secretary, as a former colleague from New Jersey and of course now as Secretary of the Treasury. I want to thank you as well for sharing with us your views on S. 648, the Market Reform Act of 1989.

As you know, this legislation was requested by the Securities and Exchange Commission. Senator Heinz and I introduced it in March of this year, and the Securities Subcommittee held a hearing on the legislation in May of this year.

I might add that a number of firms in the securities industry have strongly opposed certain provisions of the legislation. I think it is important that we hear from you and hear your strong support for the measure. Although it is getting late in the session, I would hope that we might be able to move to a mark-up in the near future. I have briefly discussed this with Chairman Riegle, and our hope is that we can iron out whatever differences may remain on this, as something that we can complete action on before we adjourn in this first session of Congress.

I have also asked Secretary Brady to talk about some of the broader issues affecting our capital markets and investor confidence in those markets.

I believe we all agree, Mr. Secretary, that the securities markets of this country are a vital national asset. They have long been considered the strongest, fairest, and most liquid markets in the world. Thousands of American companies depend upon our broad public market for capital, for long-term investments and economic growth. The jobs of millions of Americans depend upon the continued health of these markets in serving the capital needs of business. Just as important, millions of Americans rely upon the fairness in these markets when they invest their savings.

But this incredible capital-raising machine that has served us so well has changed very dramatically in recent years, and the pace of that change is accelerating.

We now see a market that is dominated by institutions, and literally whipsawed by huge, computer-driven trades. Individual investors, who have long been a source of stability and liquidity in the market, are leaving the market in large numbers. Professional players have developed trading strategies with futures options and stocks which can send the market into a tailspin and, just as quickly, as we have seen recently, drive prices to new highs.

Today, we see a market which in the last 6 years has been used to retire nearly $600 billion of equity and to add over $1 trillion in new debt to corporate balance sheets, through takeovers and leveraged buyouts and corporate restructurings as well.

Just as we have entered the age of leverage and speculation, we have entered the age of consumption. The American savings rate is far lower than our global competitors. This has major implications, as we all know, for the strength and competitiveness of our financial institutions and markets. Indeed, it poses a threat to our future economic security.

Having said this, I would still say that our markets remain the great engine of capital formation in this country. Through these markets, we have the ability to provide the patient, long-term capital to keep our economy growing. I believe—I think we all believe, Mr. Secretary—in a free market; but we also understand that there inevitably will be excesses in free markets.

The responsibility of this committee today, with your help, I would add, is to determine just what is the role of regulation in these markets. How do we encourage innovation and permit risk-taking, which we all agree is an important part of capitalism, but preserve the fairness and integrity of our markets and maintain investor confidence in them?

Do we rely on the market itself to curb the excesses of its participants; or do we step in at an early point with regulation or greater supervision? Instead of a higher degree of regulation, do we reexamine incentives provided in existing laws, such as the tax code's preference for debt financing?

These are difficult questions, Mr. Secretary. In view of your experience in the private sector and in public service, I can think of no one better to work with us in addressing these important issues.

Again, I thank you on behalf of the full committee for being with us this morning.

Let me turn to my colleagues and see if there are any opening statements or comments they would have.

Senator Heinz.

OPENING STATEMENT OF SENATOR HEINZ

Senator **Heinz**. Chairman Dodd, thanks very much.

I want to join you in welcoming Secretary Brady to our committee and to express, as you did, our gratitude to Don Riegle and Jake Garn for their scheduling this as a full committee hearing, recognizing the jurisdiction of our Securities Subcommittee.

Mr. Chairman, you are quite right on the need to move ahead on S. 648. It is critical that we explore today what the administration's position or problems, if any, with that legislation are, because time is running out.

I would just like to make a couple of observations relevant to that, as to what I mean by "time is running out." I do not know how people felt on Friday the 13th, but I suspect there were many investors who, as they watched the market drop, thought their time was running out. There was a damage assessment conducted over the weekend, a little bit like they have been doing after the earthquake in San Francisco. Investors waited rather anxiously to find out whether a "Black Monday" was going to emerge like it did in 1987.

Fortunately—and I think a lot of credit is due to the reforms recommended by the Brady Commission, and by private citizen Brady—disaster was averted. There were some improvements in the market's infrastructure. The market's electronic highways remained open, as many investors sped towards the exit ramps on Wall Street. Special express lanes were open for small investors, and traffic was halted at designated intervals in the futures market to permit investors to assess the conditions up ahead.

The Federal Reserve Board let it be known that it was going to advance adequate credit to fuel brokers running low on liquidity. I think we are all pleased—I am pleased— that the market's infrastructure is indeed stronger.

But the markets need to be a stable bridge that links corporations in need of capital with investors willing to commit their funds for the long haul. Frankly, I am worried that what Wall Street has constructed still looks more like a roller coaster than a stable bridge.

The market's structure, of course, has been built to accommodate its most frequent travelers. Those are the institutional investors, who today dominate the stock market. They own 50 percent of the equities, they account for 70 percent of the trading, and the gyrations of our markets in part reflect the trading decisions of institutional investors who seem more interested in a day trip or a joy ride than extended travel down the road to long-term investment.

Program trading in particular enables these institutions to put their investment decisions on automatic pilot, and the result is that trading inevitably heads in the same direction at the same time. There is a computer-driven herding instinct, and it turns into a stampede.

Mr. Chairman and Secretary Brady, I am concerned that the preoccupation with short-term trading rather than long-term investing is taking its toll on the capital formation process, a subject that Secretary Brady has addressed many times. It is my belief that this is clearly a more volatile market. It is my belief that volatility hampers corporate America's ability to plan its entry into capital markets. The signals on Wall Street, by the fact that they can change from green to red in minutes, mean that not only are the corporations unable to plan, but for the individual investor it is always a yellow caution light. They are saying, "I am not going to cross the street and get involved in investing."

It also seems to this Senator that some institutional investors also seem more interested in owning the market, in the form of stock indexes, rather than owning the corporate assets and earnings that that equity represents. As a result, corporations that are owned by everyone tend to be accountable to no one.

Corporate management in search of owners that possibly change may be left without direction. Corporate management seems forced to cater to the whims of fickle institutional traders, rather than the long-term demands of an increasingly competitive marketplace.

Mr. Chairman, I know that Secretary Brady shares many of these concerns. I am pleased that he has placed at the top of his agenda efforts to encourage capital investment and capital formation. As the chairman of the Presidential Task Force on Market Mechanisms, he set an agenda for stock market reform, and he is in a unique position now, as Secretary of the Treasury, to fulfill this.

The SEC, Mr. Chairman, as you stated, has recommended a basket of market reforms. I was pleased, Mr. Secretary, to join Chairman Dodd in introducing the Market Reform Act of 1989. We do need your comments as to the extent to which they would help address some of the specific concerns and problems that I've mentioned.

Thank you, Mr. Chairman.

Senator DODD. Chairman Riegle.

OPENING STATEMENT OF CHAIRMAN RIEGLE

The CHAIRMAN. Thank you, Chairman Dodd.

Let me say to you and to Senator Heinz how much I and the committee appreciate your leadership, both to the issues being covered today and within the Securities Subcommittee generally.

Secretary Brady, let me just say that I think we have had an excellent working relationship, a relationship that you and your people in the Treasury Department have had with this committee. I think we have been able to cover a lot of ground and get a lot of things done this year, like the savings and loan legislation. I think we have an opportunity here as well to move some legislation that is very important, and to do it this year, as has been suggested by the others who have spoken.

We received a letter from you yesterday in which you say, and I quote you, "The four proposals in S. 648 are timely and important, and the sooner they are enacted the better prepared we will be for future market volatility." End of quote from you in your letter of response. I think that is a very powerful statement, and it is clear-cut, and it is appreciated by the committee.

I know that in some areas right now there are sharp points of difference. The capital gains debate which is going on in the Finance Committee, on which Senator Heinz and I also serve, is an area where there are some sharp differences of opinion right now between members of Congress and the Administration. So we are trying to come to some kind of resolution of those differences.

Here I think we have an area where we have a substantial body of agreement. I think it is very important that we demonstrate that we can show good, solid, bipartisan progress and accomplishment in areas of important national need when in fact our thinking winds up as I feel it does in this area.

So I would like to just say that I think it is especially important, given the market volatility, that you are obviously concerned about it in the future, as your letter states, and as I am. We really ought to take the occasion to refine the bipartisan relationship that we have developed and get this piece of work done.

I am willing to work as hard and as long as I know my colleagues here are on a fully bipartisan basis with the Administration to get this done, hopefully this year. I hope we can do that in that spirit. I know we have talked before along those lines, and perhaps you can address that a little bit later on in your own comments.

Senator DODD. Thank you.

Senator Garn.

Senator GARN. Mr. Chairman, in the interest of everybody's time, I will ask unanimous consent that my statement be placed in the record.

Senator DODD. Without objection, so ordered.

STATEMENT OF SENATOR JAKE GARN

Senator GARN. Mr. Chairman, its a pleasure to welcome Nick Brady before this committee once again. His appearance today is very timely in light of market events of the past week and a half.

I would just like to make three brief observations about the recent market volatility—particularly Friday, October 13th's 190 point market plunge and the following Monday's 88 point upswing.

Most importantly, the events of the past week and a half, and even the 1987 crash, have provided compelling evidence that the heavy hand of Congress is not necessary to overhaul and overly regulate our Nation's securities markets. The markets survived the 1987 crash and weathered the 1989 crash without congressional intervention. Improvements made by the market participants themselves in the past 2 years have clearly enhanced the ability of the markets to smoothly function during periods of extreme volatility.

That is not to suggest, however, that some further improvements are not in order. The SEC has recommended certain market reforms to improve our clearance and settlement system and provide it with an enhanced ability to monitor market activities and assess the financial risks of market participants. This is appropriate and I know that Secretary Brady is supportive of these measures. He has expressed some concerns about specific aspects of the legislation, as have industry representatives, but it appears that these are resolvable differences.

Recent events also indicate that market volatility won't lessen until Congress deals responsibly with issues such as the trade and budget deficits and capital gains. Congressional initiatives to restrict airline takeovers and limit the tax benefits of certain kinds of debt have served to make the markets skittish. Stable markets are dependent upon a financial environment that allows for future planning with some degree of comfort. Thus, while announcement of problems with the United Airlines transaction may have been the spark that set off the market on Friday, concern about the above factors was the kindling that made the fire possible.

I look forward to Nick Brady's views on the Market Reform Act and other steps he might suggest to improve the strength and stability of our markets. I also know that he feels very strongly about the importance of the capital formation process and investing for the long-term, and I hope that we will have an opportunity to discuss these issues as well.

Thank you, Mr. Chairman.

Senator DODD. Senator Sarbanes.

OPENING STATEMENT OF SENATOR SARBANES

Senator SARBANES. Thank you very much, Mr. Chairman.

I will be relatively brief. Mr. Secretary, first of all I subscribe very strongly to what my colleagues have said about the importance of the capital markets and their integrity and safety. Obviously, that has been once again underscored by the recent developments.

I have to admit to you some concern on the movement on this matter. My understanding is that the facts I am giving you—and if you disagree with them I would be anxious to hear about that—Senators Dodd and Heinz, the Chairman and the ranking member of the relevant subcommittee, introduced S. 648, the Market Reform Act, in March of this year, last March, and wrote to you shortly thereafter right at the beginning of April, seeking your testimony and also seeking your views on this legislation.

Unless I am badly mistaken, your response to that inquiry for comments on that legislation—after all, we look to you I think, essentially, as the key actor in this matter, not only because of your current position as head of the Treasury and current position as Secretary of the Treasury, but also because of your previous experience in heading up the special commission—that letter was not responded to until the 24th of October. In other words, 2 days ago, and of course after the market experienced another sort of "October crisis."

It seems to me that it only underscores the necessity to move on some of these matters. I know your response is, "Well, why doesn't the Congress move without us?" We are obviously not seeking to do that; we want to move with you. It seems to me that this large gap in time between a request on April 6th and a response on October 24th gives us some concern.

It seems to me that we need to focus on this, and focus obviously ahead of the problem instead of after it.

Thank you, Mr. Chairman.

Senator DODD. Senator D'Amato.

OPENING STATEMENT OF SENATOR D'AMATO

Senator D'AMATO. Thank you, Mr. Chairman.

It is good to see the Secretary. I might mention to the Secretary that I think there seems to be increased concern about the kind of roller coaster ride that the computerized trading has brought about. Some call it the "computer cowboy roller coaster ride." At least that is what my staff has prepared for me in some written notes. [Laughter.]

I might note that three other staffers did the same for their Senators—I will not identify them. But these are pretty sound thinkers—I am not talking about the Senators, now. [Laughter.]

Mr. Secretary, I find it interesting that today we find two things. The Wall Street Journal has a story that talks about one-half of all program trading on the New York Stock Exchange was in index arbitrage. I had a talk with a rather successful captain of one of the major brokerage houses—I promised him anonymity—and he suggested to me that this was a problem. This does not provide capital formation, in the truest sense; and, while there seems to be a concern among some of the large brokerage houses, they are not willing to give up the profits in clicking this off, catching them on the differences, a rather technical area.

I do note that Kemper Financial Services (and this again is in the Wall Street Journal), charging that program trading is running the stock market, cut off four big Wall Street firms from doing any of its stock trading. I think that is an area of concern that we have to deal with, we must face up to.

I think we are looking to you and people like yourself for some of the guidance, so that we do not come down in the manner which exacerbates the problem and makes it difficult for capital formation, but certainly in a manner which deals with the problems. If there are people who are manipulating this market to take a short-term profit, and this is creating this roller coaster effect, what if anything can we do, and what should we do?

It is good to see you here, Mr. Secretary.

Senator DODD. Senator Dixon.

OPENING STATEMENT OF SENATOR DIXON

Senator DIXON. Mr. Chairman, I am pleased to be here this morning, as we hear from my good friend, the Secretary of the Treasury, Nick Brady on S. 648, the Market Reform Act of 1989, and on other issues related to the strength and soundness of the U.S. securities markets, 2 years after the October 1987 market break.

There is much in Secretary Brady's prepared testimony with which I agree; however, I cannot agree, Mr. Chairman, that issues related to futures margins levels need to be reconsidered. It seems to me beyond dispute that futures margins levels are demonstrably sufficient for safety and liquidity purposes.

There are a lot of reasons futures margins are clearly sufficient. I would point out just two: No. 1, futures markets clear much more quickly than the stock market. No. 2, futures margins are adjusted even during the day, as margin movements call for it.

This system works, and it has worked very well.

The reason volatility has put no strains at all on the liquidity or safety of the futures market—I think it is worth remembering that for a significant period during the recent 190-point 1-day drop in the Dow Jones index on the New York Stock Exchange, the S&P pit of the Chicago Mercantile Exchange was closed. It was closed because of the circuit breaker that both New York and Chicago agreed to; yet the stocks continued to decline by large amounts, even with no futures markets activity.

Futures market margins have nothing to do with that volatility. In fact, I do not believe that any mechanical market mechanism had anything to do with the recent volatility that our markets have been experiencing. Instead, I believe we need to look at the real issue, the fundamental changes in the character of our capital markets, in who owns stocks, and in their trading strategies.

We also need to keep in mind the fact that financial markets are now international and very closely aligned. Artificially raising futures market margins would have no impact on market safety, but it could very well move business to foreign markets. If that business is once lost, Mr. Chairman, it would be extremely difficult to recover.

Senator **Dodd**. Thank you, Senator Dixon.

Senator Gramm.

OPENING STATEMENT OF SENATOR GRAMM

Senator **Gramm**. Mr. Chairman, I want to pick up to some extent where Senator Dixon left off. Let me thank our distinguished Secretary of the Treasury for coming today.

I'd like to remind members of this committee and the Secretary that financial markets are international, that we are in competition with every other financial market in the world, and that if we drain the pond and stop feeding the goose and burn down the coop and let the dog loose to chase it around the barnyard—it is probably going to fly off somewhere else and make another country rich.

A second point I would like to make is that while we talk about all this instability, nobody ever addresses the fact that the instability always occurs at the same time of the year, in the middle of October. What happens in the middle of October? What happens in the middle of October is, we have financial chaos in the Congress, because Congress cannot make a decision.

We create the instability, then we blame the thermometer for indicating that the temperature of the patient has gone up from a disease that we caused, and then we investigate the thermometer, instead of treating the patient.

Second, I think we need to go back and look at circuit breakers, because as I look at the data they not only do not work, they make the problem worse. Circuit breakers made sense when we didn't have clearing capacity, and so we were seeing markets break down; but there is nothing more destabilizing to a market than the lack of an ability to buy and sell. I think we need to look at the data on October the 13th, now that we have expanded capacity, and ask ourselves if in fact circuit breakers have helped. As I look at the data, they have not helped; they have hurt.

Let me also, Mr. Chairman, say something about computer trading and program trading. I feel passionately about this—and I hope I do not hurt anybody's feelings—but I have never heard more nonsense in my life from people who are supposed to be knowledgeable on these matters than what is being said about computer program trading.

The idea that we can limit the ability of people to use modern technology to make investment decisions in this great capitalistic country is absolutely and profoundly astonishing. The idea that someone investing his life savings should not have the ability to use a computer or a program—it is just astoninshing. They are trying to promote their own well being, in the process making us the richest and the most prosperous nation on earth.

The idea that somehow we should have the ability to come in and ban the computer, or ban program trading, is a "know-nothingism" that rivals the "know-nothing" policies of the 1800's in this country.

If we can make markets work better by banning modern technology, it is only a matter of time until we get down to the telephone and the ballpoint pen. [Laughter.]

It is absolutely astounding that this kind of nonsense passes as some kind of approach to dealing with market problems.

Finally, so as not to overstay my welcome, Mr. Chairman, I remind everyone that markets go up and down; markets are barometers that measure what is happening in the country. They measure expectations about future profits.

Our role, as I see it, is to be sure that those markets are efficient, that they have clearing capacity, that they have liquidity, and that they are scrupulously fair and honest. Beyond that, it is not our job to write laws that say markets ought always to go up, or that we ought to suspend them when they go down. That is just nonsense that interferes with the ability of the market system to do its work.

I am deeply concerned about it. I think we are tampering with the very heart of the American economic system. I think that we ought to go very slowly, and be very careful.

Senator DODD. Senator Shelby.

Senator SHELBY. Mr. Chairman, in the interest of time here, I think, Mr. Secretary, it will be early in the afternoon before we get to you. I hope you have got something soft to sit on out there. [Laughter.]

I want to hear your remarks. I will try to be brief. I do have a prepared statement, Mr. Chairman, that I would like to have made part of the record.

Senator DODD. Without objection, so ordered.

STATEMENT OF SENATOR RICHARD SHELBY

Senator SHELBY. Mr. Chairman, I commend you for scheduling today's hearing. Discussing this subject now is particularly timely, since today is exactly 2 years and 1 week after Black Monday.

Jitters in the high yield bond market and speculative trading in takeover stocks, among other factors, have led to turbulence in the marketplace lately. Volatility and uncertainty are frightening investors, prompting even John Phelan to advise that investors may be better off staying out of the market for a while.

Philosophically, I am generally opposed to interfering with the mechanics of the marketplace. I have a firm belief in the forces that make the market work and believe generally that market forces are superior to artificial constraints, particularly those imposed through Government intervention.

The dynamics of the marketplace have changed in recent years. Institutional investors are playing an increasingly important role, for better or for worse. Small investors have become intimidated by the marketplace and this fear makes it likely that the trend toward institutionalization of assets will continue. This magnifies the ability of any one investor or group of investors to alter market values.

Technology has made program trading possible, tremendously increasing exchange volume, as enormous blocks of shares are bought and sold rapidly. The rapid changes in price made possible through program trading further distance the small investor, concerned about his priority in the order of execution.

We did not act hastily in response to Black Monday and I believe history reveals that to have been wise. The past 2 years have been relatively stable in the marketplace. The self-regulatory organizations have adopted reforms and increased their capacity while synchronization between markets has been improved.

However, that does not mean that improvements cannot be made. The Securities and Exchange Commission has made specific proposals for reform, which have been incorporated into legislation and introduced by the distinguished leadership of the Securities Subcommittee. These four areas, which include (1) emergency powers for the SEC, (2) clearance and settlement procedures, (3) large trade reporting, and (4) risk assessment for financial holding companies are legitimate areas of concern and would not obtrusively interfere in the mechanics of the marketplace.

Mr. Chairman, I appreciate the effort that you have put into this subject and I am glad for the appearance before the committee of the distinguished Secretary and the primary author of the Brady Commission report. I look forward to the light that he can shed on this subject.

Thank you.

Having done that, Mr. Secretary, there is something that does bother me. I know we are in the age of technology, and I know we do not go backwards, and I agree with Senator Gramm that we should not go backwards—otherwise we could turn the lights off in a few minutes and everybody would be thinking you are whispering because we would not have the microphone.

But I am concerned about the flight of the small investor which, as you well know from being in the private sector and being in your present position, is really happening out there. At the rate we are going, there will not be any small investors left. It might not be 10 years.

How do we get the small investor back in the market? They are frightened, they are scared, they feel like they have no control of events, or even no way to influence events. I think that the small investor historically has paid a tremendous role. Perhaps he will not play a big role in the future, but I think it is important.

You can look at the brokerage houses, the retail business and so forth, and the thousands of people who have been laid off. Without confidence by the small investor, will the market just be for the big boys?

Thank you, Mr. Chairman.

Senator DODD. Thank you, Senator Shelby.

Again, Mr. Secretary, thank you for being with us.

Senator Mack, I apologize.

OPENING STATEMENT OF SENATOR MACK

Senator MACK. I appreciate that.

I guess, being the last one to speak, there is a little pressure to be short, but I cannot help but build on the comments of my colleague, Senator Gramm, when he was talking about computer program trading and the idea that we would be talking about limiting technology.

It reminds me of a story. I come from a town called Fort Myers. Fort Myers is the winter home, or was the winter home of Thomas Edison. That is where he did a great deal of his experiments on the light bulb. The story has been told that, if Thomas Edison were alive today and he were to announce the invention of the light bulb, the CBS Evening News Tonight with Dan Rather would report that, "Today, the candle-making industry was threatened," and some member of the Congress would go to the floor of the Senate or the House to propose legislation to protect the candle-making industry.

I find that we are exactly in the same situation here. There is a tendency on the part of the Congress to point fingers at other institutions for the faults that they have created. Again, you go back to October of 1987. I remember October the 19th fairly well. I think that was the date, wasn't it?

I was announcing that I was running for the United States Senate. I might add that I got very little coverage that day, as the market fell 500 points. [Laughter.]

But I do recall the debate we got into as a result: What caused the market to decline? I know that in your report you indicated that one of the events was the passage by the House Ways and Means Committee of a piece of tax legislation that was going to limit the deductibility of interest on loans that were used for the purpose of purchasing over 50 percent of another company.

The market reacted to that. I would make the claim that the market reacted again on October the 13th, Friday, when they found out that the Senate was not going to deal with the capital gains legislation. The market believes that if you lower capital gains, the asset values are going to increase and, as a result of that increased asset value, the market is going to increase.

The market at that time, when the House passed the capital gains, was 2773. On the 11th of October, it was 2773, 100 points up. Today, the market is 2653. What I am saying is that the market reevaluated. It said that since the opportunity for a lower capital gains may have been lost, therefore rates were going to be higher than what they anticipated. The value of assets again dropped, and the market reevaluated those assets.

So I share some very, very strong feelings, expressed by Senator Gramm, that we are doing the wrong thing. We are in the process of putting shackles on a free market, and I think that is wrong.

Senator DODD. Thank you, Senator Mack.

I would point out that, with respect to the legislation we are talking about here today, S. 648, two of the four major provisions are reporting requirements to gather more information. The third has to do with improved coordination of the clearance and settlement.

When I hear some of these arguments, they are sort of the Washington Monument arguments. The argument was raised, but no one has even suggested it; namely, that I wanted to stop program trading, or to do away with computers and ballpoint pens.

What we are trying to do is, of course, to increase the availability of information, so we can make intelligent decisions. I would suggest that maybe my colleagues might spend some time reading the legislation before they speculate about what we are doing.

So I welcome again the Secretary.

Senator SARBANES. Mr. Chairman, could I just ask an informational question? I could not find in this bill the provision that bans the computers.

Senator DODD. You will not find it in this legislation.

Senator GRAMM. Mr. Chairman, may I respond, since apparently I have created the view?

I was responding to all of this roller coaster business, and these roller coasters have always frightened me, even as a child. When people start talking about these things, I notice they start ending up in bills.

So it was not that I was saying that the forces of darkness and evil have overtaken your bill; it is just that they are always so much in evidence here.

Senator DODD. I was concerned that there was maybe some confusion over that. I am glad my colleague from Texas is not confused.

Senator D'AMATO. Mr. Chairman, if I might add to the confusion——[Laughter.]

Senator DODD. We are going to get to you eventually, Mr. Secretary.

Senator D'AMATO. I have always been concerned about that roller coaster. I will tell you something: I would not even ride that one in Coney Island, where I grew up, as a kid.

I have to tell you that we are not talking about—nor am I suggesting—banning program trading by use of the computer. However, there seems to be a very real abuse of the system as it relates to futures and indexes, etcetera, which have been used to protect against great market fluctuations. If someone enters into a contract, they buy a future, it is a hedge, during the construction period of something that the market does not move up and down so much. They are paying an insurance premium to guard against a great fluctuation. Farmers use it, and traders use it, in that traditional sense.

It was never intended to create instant profits as a result of the market moving in one direction, being triggered off, and then moving in quickly to capitalize on the differential on that future.

That is what is happening, and that does not have a damned thing to do with the computer.

But in the age of computers, and in an age of millions of these trades being able to be made instantaneously, what happens is that the large brokerage houses are able to come in and to capture a differential which means millions of dollars to them.

To put it bluntly, that is not what it is about. Because what you are going to do is, you are disadvantaging the small trader who is out there buying, the small investor who is investing his dollars. It was never intended, those futures and those indices were never intended for profit-making in that manner. That is exacerbating the roller coaster effect, and that is what we have to examine.

I thank you.

Senator DODD. Thank you, Senator D'Amato.

Mr. Secretary, we have a vote. Rather than getting you started on your testimony—now that you have had an opportunity to hear all of this wisdom from this side of the table——

Senator SHELBY. Mr. Chairman, can I suggest that it be early afternoon before he gets back?

Senator DODD. We will take a 10-minute break here.

The CHAIRMAN. Mr. Chairman?

Senator DODD. Chairman Riegle.

The CHAIRMAN. Before we go out the door, I also want to place in the record at this time a letter that I sent to you, Mr. Secretary, and also to the SEC Chairman earlier this month, on the issue of junk bonds.

I want to say that I will very much look forward to your response on that letter, Mr. Secretary. Also, of course, we look for Mr. Breeden's response. That subject has not come up as yet. The letter is important. I know you have it, and you will respond of course.

[The letter referred to follows:]

DONALD W. RIEGLE, JR., MICHIGAN, CHAIRMAN
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United States Senate
COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS
WASHINGTON, DC 20510-6075

October 5, 1989

The Honorable Nicholas F. Brady
Secretary of the Treasury
Room #3419
1500 Pennsylvania Avenue
Washington, D.C. 20220

Dear Mr. Secretary:

Recent events, particularly the financial difficulties of Campeau Corp., have focused attention again on so-called "junk bonds" and the financings in which they have played a major role. These financings have typically resulted in debt-equity ratios vastly in excess of those which have traditionally been regarded as prudent by American businessmen and financing instrumentalities. They have, in effect, displaced significant amounts of equity in many American corporations with potential consequences which have not to date been sufficiently discussed or understood.

Junk bond financings have been part of a broader capital market process involving the "privatization" of the equity markets and the "securitization" of the debt markets. This process, particularly the "securitization" of debt, has exposed markets to new risks and involves issues of control and disclosure that do not appear to me to be adequately addressed by current regulations and oversight practices.

Today, in a highly leveraged corporation, control is often not in the hands of the shareholders. True, they may have certain rights resembling those possessed by shareholders in conventionally financed corporations, but in truth the exercise of those rights and the destiny of the corporation is heavily influenced or controlled by the holders of the debt securities of the corporation.

Moreover, there has been expressed in Congress, and elsewhere from time to time, concern over the concentration of economic power through the ownership of corporate equities in various institutions and entities. This concern has always been related to equity ownership concentration.

Further, in view of the widespread belief that we will witness an increasing parade of troubled LBO's which may cause serious losses to holders of "junk bonds" (already "junk bonds" and "junk bond funds" have been discounted in the market), it is important for the nation and its policy-makers to know which types of financial institutions are holders of significant amounts of this jeopardized paper. To the best of my knowledge no one has assembled this information, which could be of significant interest to those vested with the responsibility for developing major financial policies in this country.

For example, if the Senate Banking Committee wanted to find out in any detail the size and ownership of the holdings of junk bonds by pension funds, insurance companies, banks and securities firms, that information would be very difficult to come by since it is not accumulated on a centralized basis anywhere within the government. What information is currently available in the aggregate is at best suspect.

I would urge that the Treasury Department, in collaboration with other relevant agencies of the government, develop the means of securing, assembling and publicizing information concerning the holders of "junk bonds." Knowing who are the risk-takers in this new financial environment could be very helpful to you and others in developing policies for dealing with what increasingly appears to be the likelihood of wide-spread defaults under such securities, and such information would be helpful to the public in formulating its convictions with regard to economic policy.

In addition, thought must be given to improving the information about the market for these less than investment grade securities so that individual investors and others may be informed on a real time basis what the bid and ask price are for these instruments and the extent to which they are liquid and marketable in the secondary market. Given the fact that public markets have been a central element in the growth of junk bond financing, the SEC must take steps to ensure that a modernized quotation system is put into place.

There are undoubtedly other issues related to the proliferation of new and inventive debt securities and to the use of the public securities markets to leverage the U.S. economy that the Treasury and the SEC might feel appropriate to address.

I appreciate your attention to these issues and look forward to your written response to the suggestions I have made.

Sincerely,

Don

Donald W. Riegle, Jr,
Chairman

cc: Richard C. Breeden

Senator **Dodd**. Thank you.

The committee stands in recess for 10 minutes.

[Recess]

Senator **Dodd**. The committee will come to order.

Mr. Secretary, if you will take your chair, we have now had an hour of listening to us in a hearing which we convened to listen to you. So we will get about the business of listening to you. We welcome you.

STATEMENT OF NICHOLAS F. BRADY, SECRETARY, U.S. DEPARTMENT OF THE TREASURY

Secretary **Brady**. Chairman Dodd, Chairman Riegle, Ranking Member Garn—and I see Senator Heinz is not back—I wanted to start off by welcoming the members of the subcommittee. I appreciate the time that you and your staff have given us on this legislation.

Again, I always refer to Senator Riegle's testimony that we have had close cooperation with this committee, and that is exactly the fact. We appreciate the effort and the work that that has taken, both from you and from the ranking members.

In the interest of time, I will summarize the written statement that I have submitted for the record.

The committee certainly picked an appropriate time for this hearing. The market's fall and rise on October 13 and 16 underscore the continuing potential for volatility. It also showed us the real progress that has been made in several areas, and highlighted some steps that we should take to reduce the chances of major market disruptions.

One important step is the enactment of the four proposals contained in S. 648, "The Market Reform Act of 1989." Another is the continuing effort of the Working Group on Financial Markets which addresses such key issues as circuit breakers, margin requirements, and clearance and settlement.

While my testimony today will address each of these steps, the time has come to acknowledge that the global securities markets are indeed linked. In exploring international and intermarket linkages, I believe the United States should lead the way. The Working Group decided just this week to begin the initial efforts to do so.

In today's testimony, I will describe some of the reasons for these actions. First, let me begin my remarks with a brief description of the market's sharp swing two weeks ago, and the general condition of the market's since October 1987.

The decline of the stock and futures markets on Friday, October 13th raised fears of a repeat of the Friday before the Monday collapse in October 1987. The Dow Jones Industrial Average lost 190 points, the second-largest point drop ever, and the 12th largest in percentage terms.

Obvious imbalances existed between markets in New York and Chicago, as they had in 1987. Yet, as we know, despite the fourth-largest trading volume in history, on Monday the equities market recovered 50 percent of its losses without incident.

We will know much more about the events of two weeks ago, and how they compared with October 1987, when studies now underway by the regulatory agencies have been completed. Yet preliminary observations can be made.

First, as I said on October 13, it is important to recognize that the Friday decline does not signal any fundamental change in the condition of our economy. We continue to believe that the economy is well-balanced, with prospects for continued moderate growth. I am pleased to see this morning the GNP figures of good, solid growth, with a lowering of the rate of inflation.

Second, in many ways I think we can be reassured by how well the system functioned. Few of the operational problems witnessed in 1987 occurred, and although investor concerns were understandable, there was obviously a greater sense of confidence by all market participants. Contributing to this sense of confidence was a general recognition that markets in New York and Chicago really act as one market.

Furthermore, the systems that were put in place over the last 2 years to address market gyrations appeared to have worked reasonably well. As in 1987, the futures market led the other markets down, but this time "circuit breakers" were triggered twice. They seemed to perform as designed, and appeared to relieve some of the pressure on the stock market. However, their performance needs to be analyzed carefully, in order to draw any final conclusions.

Another positive development was the computer capacity added by the securities exchanges, which seemed more than adequate to handle the exceedingly high volume on October 16th. As you know, the exchanges and the over-the-counter market soon will have the capacity to handle one billion share days, which will further improve market operations.

Over the weekend following October 13, members of the Working Group were in constant communication with each other, the self-regulatory organizations, and the domestic and international markets. Together, we collected information about risk to the system and major participants, and what reaction we could expect at both the retail and institutional levels.

Our most pressing concern was market overhang, the unfinished business that we hoped would not flood the market with sell orders on Monday. The futures market on Friday closed at a discount to the stock market, which was equivalent to 50 points on the Dow Jones average. This was a significant discount, and an obvious cause for some concern.

As a result, we canvassed retail firms, major investment banks, institutional investors, M&A arbitrageurs, and mutual funds, to assess conditions in the market. While we learned much that was helpful, other information that would have made our task easier, such as large trader data in the stock market, was not available. I believe that during our next period of market turbulence, it would be extremely helpful to have that data before us.

Apart from the events of October 13, there is both good news and bad news about the current condition of the securities markets. The good news is that: Distortions from portfolio insurance have more or less disappeared. Price-earnings ratios seem more in line with fundamentals. The economy continues to expand and the stock market has recovered from October 1987. The Working Group has helped to substantially lessen possible systemic dangers to the U.S. financial system.

There is also some less good news: Participants, both institutions and individuals, have left the market in numbers. The amount of new equity issued in the markets is off substantially, even in the face of an expansion. For the first half of 1989, initial public offering volume was down 60 percent from the first half of 1987. And finally, extreme cases of market volatility continue to occur, as we were just reminded on October 13 and 16.

In short, some of the specific weaknesses in market mechanisms are still with us and must be addressed. That is the reason that I believe the legislation before this committee represents important steps in the right direction.

As you know, we recently sent the committee a letter expressing administration support for "The Market Reform Act of 1989," which is attached to my written statement. The bill's four proposals, which respond to issues raised by the 1987 market break, would:

1. Authorize the SEC to take certain actions in a market emergency;
2. Authorize the SEC to require large trader reporting;
3. Facilitate linked or coordinated clearance and settlement; and
4. Authorize the SEC to require reports from broker-dealers concerning risks posed by their affiliates.

The administration believes that all four proposals, with some modifications, will better prepare us for future market volatility. Since the letter attached to my written statement details our reasons why, I will not repeat them here. I will only say that we stand ready to provide any technical assistance that the committee may require.

We are generally pleased with the progress of the Working Group on Financial Markets, consisting of the Treasury Department, the Federal Reserve, the SEC, and the CFTC. Indeed, through the constructive actions of market participants, regulators, and SRO's, the Working Group has accomplished much of what was advocated by the commission I chaired in 1987 and 1988, the Task Force on Market Mechanisms.

The Working Group focused on the significant suggestions of the Task Force and others that could reduce systemic dangers to the U.S. financial system in the event of another severe decline such as we saw on the 13th of October and two years ago.

Most importantly, the Task Force's fundamental premise has been widely accepted—that stock, futures and options markets are linked as one market. This recognition of one market has prompted the private sector to adopt the Task Force's recommendation of coordinated circuit breaker mechanisms: the joint plan of the securities and futures exchanges to establish coordinated trading halts. We applaud the decision in October to extend the circuit breaker between the New York Stock Exchange and the Chicago Mercantile Exchange for another year.

In addition, the Working Group is currently reviewing the timing of release of important government economic data on days when contracts for equities, options, and futures expire—the so-called triple- and double-witching days. We will also analyze the regulators' review of the performance of circuit breakers on October 13th and whether they need to be modified.

In short, the Working Group has created a process for coordination, dialogue, and cooperation that has continued in this Administration. Staff has met regularly since the beginning of the year, and in the short time since Chairman Breeden's recent appointment to the SEC, we have held two meetings of Working Group principals. I believe that three of our most important agenda items are globalization of the securities markets, margin requirements, and clearance and settlement issues, which I would now like to discuss.

The Task Force I headed two years ago concluded that our domestic stock and futures markets are so closely linked as to constitute one market requiring coordinated policies and procedures. Although the world's securities and derivative markets are unified in only some respects, the evidence of their close linkages and interdependence has continued to grow.

International transactions in securities have soared from levels earlier in this decade. Foreign purchases and sales of U.S. Treasury notes and bonds surpassed $3 trillion last year. Total foreign portfolio investment in the United States has increased from $74 billion in 1980 to $394 billion in 1988, while U.S. portfolio investment in foreign countries has risen from $63 billion to $157 billion.

The growth of international indices and global funds feeds back into the demand for many U.S. securities, making them subject to conditions in world markets. Vastly improved technology has created instantaneous world-wide trading and information sharing.

This rapid expansion of global securities markets suggests that we should consider the interrelationship among markets on a global scale. The Working Group decided this week to identify particular issues where an international and intermarket approach would be useful. We will certainly keep Congress fully informed and consult with other countries as we proceed with efforts in this area.

As you know, the Task Force that I chaired on the 1987 market break recommended that margin requirements be harmonized between the equity and the derivative markets. In 1988, the Working Group concluded that the then-current margin requirements were sufficient for prudential purposes, and consistent between the two markets.

However, the futures markets subsequently reduced their minimum margin requirements to levels even lower than before the 1987 collapse. This raises questions whether futures and equity margin requirements are consistent at these levels, and whether futures margins are adequate.

I am very concerned about these issues, because I believe there is a public interest involved beyond the private interest of the exchanges. I therefore intend to ask the Working Group to reconsider issues related to margin requirements.

Finally, let me mention one other item on the Working Group's agenda that is critically important, the intermarket clearance and settlement system. Sufficient progress in this area has not been achieved, although the Working Group has made a number of constructive proposals. Since clearance and settlement is the weakest link in the whole system, improving it would help ensure that a securities market failure does not become a credit market failure. It would also facilitate cross-margining in a safer, more straightforward way, with possible implications for margin levels.

Clearly, much still needs to be done in this area, both domestically and in the international arena, and the sooner the better. The proposal in S. 648 to facilitate linked or coordinated clearance and settlement systems will be a useful way to facilitate this process. This and other action are essential if we are serious about strengthening the weakest link in the system.

In conclusion, there is a continuing need to modernize our domestic markets to make them operate more effectively, while at the same time identifying those areas in which an international approach would be useful. This does not require burdensome new regulation. Furthermore, we cannot and should not attempt to eliminate major market moves, whether by legislation or regulation. But we do need to ensure that our markets are configured in the best manner possible to withstand the increasing demands we have placed on them.

We should concentrate on ensuring the preeminent position of the United States' markets in an increasingly global marketplace. This is no longer a parochial tug-of-war between markets in New York and Chicago. Unless we manage and configure our markets correctly, we will not maintain our leadership in the global marketplace. This is one industry where, once we fall behind, it will be very, very difficult to catch up.

Mr. Chairman, that concludes my testimony. I will be pleased to answer questions you or other Senators might have.

[The complete statement of Mr. Nicholas F. Brady follows:]

TESTIMONY OF THE HONORABLE
NICHOLAS F. BRADY
SECRETARY OF THE TREASURY
BEFORE THE SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

OCTOBER 26, 1989

Chairman Riegle, Senator Garn, and Members of the Committee, thank you for inviting me to discuss the current state of the securities markets, their trend towards globalization, and continuing efforts by Congress and the Executive branch to address financial market issues.

The Committee certainly picked an appropriate time for this hearing: the market's fall and rise on October 13 and 16 underscored the continuing potential for volatility. It also showed us the real progress that has been made in several areas and highlighted some steps that we should take to reduce the chances of major market disruptions.

One important step is the enactment of the four proposals contained in S.648, "The Market Reform Act of 1989," which several members of this Committee have co-sponsored. Another is the continuing effort of the Working Group on Financial Markets which addresses such key issues as circuit breakers, margin requirements, and clearance and settlement.

While my testimony today will address each of these steps, the time has also come to acknowledge that global securities markets are linked. In exploring international and intermarket linkages, I believe the United States should lead the way, and the Working Group decided just this week to begin the initial efforts to do so. A description of these efforts is set forth later in the testimony.

Let me now begin my remarks with a brief description of the market's sharp swing two weeks ago and the general condition of the markets since October of 1987.

October 13 through 16

The tailspin of the equity and derivative markets on Friday, October 13, raised fears of an eerie repeat of the Friday before the Monday collapse in October 1987. The Dow Jones Industrial Average lost 190 points, the second largest point drop ever and the 12th largest in percentage terms. Obvious imbalances existed between markets in New York and Chicago, as in 1987. Yet as we know, despite a two-day layover and the fourth highest trading volume in history, on Monday the equities market recovered 50 percent of its losses without incident.

We will know much more about the events of two weeks ago -- and how they compared with October of 1987 -- when studies now underway by the regulatory agencies have been completed. Yet preliminary observations can be made.

First, as I said on October 13, it's important to recognize that the Friday decline does not signal any fundamental change in the condition of the economy. We continue to believe that the economy is well-balanced, with prospects for continued moderate growth.

Second, in many ways I think we can be reassured by how well the system functioned. Few, if any, of the operational problems that we witnessed in 1987 occurred, and although investor concerns were understandable, there was obviously a greater sense of confidence by all market participants. Contributing to this sense of confidence was the general recognition that markets in New York and Chicago really act as one market.

Furthermore, the systems that were put in place over the last two years to address market gyrations appeared to work reasonably well. As in 1987, the futures market led the other markets down, but this time "circuit breakers" were triggered twice (the 250 point circuit breaker in the equities markets was never reached). These seemed to perform as designed and appeared to relieve some of the pressure on the stock market, but their performance needs to be analyzed carefully in order to draw any final conclusions.

Another positive development was the computer capacity added by the securities exchanges, which seemed more than adequate to handle the exceedingly high volume on October 16. As you know, the exchanges and the over-the-counter market soon will have the capacity to handle one billion share days, which will further improve market operations.

Over the weekend following October 13, the members of the Working Group were in constant communication with each other, the self-regulatory organizations, and the domestic and international markets. Together we collected information about risk to the system and major participants, and what reaction we could expect -- at both the retail and institutional levels -- on Monday.

Our most pressing concern was market overhang, the unfinished business that we hoped would not flood the market with sell orders on Monday. The futures market on Friday closed at a discount to the stock market, which was equivalent to 50 points on the Dow Jones average. This was a significant discount and an obvious cause for some concern.

Over the weekend, we canvassed retail firms, major investment banks, institutional investors, mergers and acquisition arbitrageurs, and mutual funds to assess conditions in the market. While we learned much that was helpful, other information that would have made our task easier -- such as large trader data in the equities market -- was simply unavailable. I believe that during our next period of market turbulence it would be extremely useful to have that data before us.

The Current Status of the Markets

Apart from the events of October 13, there is both good news and bad news about the current condition of the securities markets. The good news is that:

- Distortions from portfolio insurance have more or less disappeared, largely due to the dramatic reduction of that program trading strategy resulting from the general recognition that it simply does not work, rather than from any regulatory actions taken in the wake of October 1987;

- Prices seem more in line with fundamentals (S&P 500 price/earnings ratios have dropped from 21 to about 14, which is more in line with historical averages);

- The economy continues to expand and the stock market has recovered; and

- The Administration's Working Group, in partnership with the regulators, self-regulatory organizations and member firms, has helped to substantially lessen possible systemic dangers to the U.S. financial system.

There is also some bad news:

- Participants, both institutions and individuals, have left the market in large numbers;

- The amount of new equity issued in the markets is off substantially, even in the face of an expansion -- for the first half of 1989, initial public offering volume was down 60 percent from the first half of 1987; and

- Extreme cases of market volatility continue to occur, with the Dow Jones down 141 points on January 8, 1988; down 101 on April 14, 1988; up 75 on May 31, 1988; and, of course, down 190 on October 13, 1989, and up 88 on the following Monday -- all of which underscore the need for market mechanisms capable of accommodating major moves.

In short, some of the specific weaknesses in market mechanisms are still with us and must be addressed. That is the reason that I believe the legislation before this Committee represents important steps in the right direction.

The Market Reform Act of 1989

As you know, we recently sent the Committee a letter expressing Administration support for "The Market Reform Act of 1989," a copy of which is attached. The bill's four important proposals, which respond to issues raised by the 1987 market break, would:

- Authorize the Securities and Exchange Commission (SEC) to take certain actions in a market emergency;
- Authorize the SEC to require large trader reporting of program or block trades;
- Direct the SEC and the Commodity Futures Trading Commission (CFTC), in consultation with the Federal Reserve, to facilitate linked or coordinated clearance and settlement of intermarket transactions, and grant the SEC authority, in consultation with Treasury, to prescribe uniform rules concerning securities transfers; and

- Authorize the SEC to require reports from broker-dealers concerning the financial or operational health of their affiliates.

The Administration believes that all four proposals, with some modifications, will better prepare us for future market volatility. Since our attached letter details our reasons why, I will not repeat them here. I will only say that we stand ready to provide any technical assistance that the Committee may require.

The Progress and Agenda of the Working Group

We are generally pleased with the progress of the Working Group on Financial Markets, consisting of the Treasury Department, the Federal Reserve, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. Indeed, through the constructive actions of market participants, regulators and self-regulatory organizations, the Working Group has accomplished much of what was advocated by the commission I chaired in 1987 and 1988, the Task Force on Market Mechanisms. The Working Group focused on the significant suggestions of the Task Force and others that could be accomplished immediately to substantially lessen possible systemic dangers to the U.S.

financial system if we were again to encounter a severe stock market decline.

Most importantly, the Task Force's fundamental premise -- that the equity, futures and options markets are linked as one market -- has been widely accepted. This recognition of one market is the basis for the important private sector initiative embodying the Task Force's recommendation of coordinated circuit breaker mechanisms: the joint plan of the securities and futures exchanges to establish coordinated trading halts in their markets. We applaud the decision in October to extend the NYSE-CME circuit breaker.

In addition, the Working Group has formed a staff subgroup on circuit breakers which currently is reviewing the timing of release of important government economic data on days when contracts for equities, options, and futures expire -- the so-called triple- and double-witching days. The subgroup will also analyze the regulators' review of the performance of circuit breakers on October 13, and will specifically consider whether they need to be simplified and whether triggers should be adjusted and better coordinated.

In short, the Working Group has created a process for coordination, dialogue, and cooperation that has continued in this Administration. Staff has met regularly since the beginning of the year, and in the short time since Chairman Breeden's recent appointment to the SEC, we have held two meetings of Working Group principals. I believe that three of our most important agenda items are globalization of the securities markets, harmonization of margin requirements, and clearance and settlement issues, which I would now like to discuss.

Global Securities Markets

The Task Force I headed two years ago to study the 1987 market break concluded that our domestic securities and derivative markets are so closely linked as to constitute one market requiring coordinated policies and procedures. Although the world's securities and derivative markets are unified in only some respects, the evidence of their close linkages and interdependence has continued to grow:

- International transactions in securities have soared from levels earlier in this decade, particularly foreign purchases and sales of U.S. Treasury notes and bonds, which surpassed $3 trillion on a gross basis last year;

- Total foreign portfolio investment (corporate debt and equity) in the U.S. has increased from $74 billion in 1980 to an estimated $394 billion in 1988;

- U.S. portfolio investment in foreign countries in turn has risen over the comparable period from $63 billion to $157 billion;
- The growth of international indices and global funds feeds back into the demand for many U.S. securities, making them subject to conditions in world markets;
- The objective of developing within the European Community a single internal market for services and capital by 1992 is evidence of the changes taking place in world financial markets;
- Vastly improved technology has created instantaneous worldwide trading and information sharing;
- Deregulation of entry barriers to domestic markets, such as London's Big Bang, has also contributed to the integration of world markets; and
- Despite the growth of international securities transactions, clearance and settlement systems differ dramatically on a market-by-market and country-by-country basis.

This rapid expansion of global securities markets suggests that we should consider the interrelationship among markets on a global scale. The Working Group will identify particular issues where an international and intermarket approach would be useful. We will certainly keep Congress fully informed and consult with other countries as we proceed with efforts in this area.

Margin Requirements

As you know, the Task Force that I chaired on the 1987 market break recommended that margin requirements be harmonized between the equity and derivative markets. Thereafter, in 1988 the Working Group concluded that the then-current minimum margin requirements were sufficient for prudential purposes, and consistent between the two markets.

However, the futures markets subsequently reduced their minimum margin requirements to levels even lower than before the 1987 collapse. This raises questions whether futures and equity margin requirements are consistent at these levels and whether futures margins are adequate.

I am very concerned about these issues, because I believe there is a public interest involved beyond the private interest of the exchanges. I therefore intend to ask the Working Group to reconsider issues related to margin requirements.

Clearance and Settlement

Finally, let me mention one other item on the Working Group's agenda that is critically important: the intermarket clearance and settlement system. Sufficient progress in this area has not been achieved, although the Working Group has made a number of constructive proposals. Since clearance and settlement is the weakest link in the whole system, improving it would help ensure that a securities market failure does not become a credit market failure. It also would facilitate cross-margining in a safer, more straightforward way, with possible implications for margin levels.

The Working Group has reviewed existing clearing, payment and settlement systems to identify and set priorities for measures to reduce uncertainty, increase coordination, assure confidence in the integrity of such systems, and facilitate their smooth operation in volatile markets. It has proposed an agenda of specific actions in the following areas:

o Facilitation of timely payments. Several features of existing clearance and settlement systems relevant to payment capacity can be enhanced to facilitate the timely satisfaction of payment obligations, including increased Fedwire availability in highly volatile markets, coordinated intermarket settlement processes, and increased availability of timely information concerning payment obligations and cash flows.

- Exploration of methods to simplify settlement systems. This would include a cross-margining pilot program for non-customer accounts in options and futures, and consideration of specific initiatives to reduce cash transfers, simplify settlements systems, and unify clearing.

- Refinement of relevant legal frameworks. It is important to harmonize transfer, delivery and pledge requirements for options and uncertificated securities at the federal level and to better coordinate bankruptcy protection for securities and commodity brokers.

In addition to these recommendations, a number of system refinements already are under way, such as the NYSE-NASD commitment to implement next-day comparisons. Useful studies have been completed or are in process, notably the Group of Thirty report in the international area and the American Bar Association task force on state laws.

Clearly, more needs to be done, both domestically and internationally, and the sooner the better. The proposal in S.648 to facilitate linked or coordinated clearance and settlement systems would be a useful way to facilitate this process. Additional prompt and effective action on clearance and settlement is essential if we are serious about strengthening the weakest link in the system.

Conclusion

There is a continuing need to modernize our domestic markets to make them operate more effectively, while at the same time identifying those areas in which an international as well as an intermarket approach would be useful. This does not require burdensome new regulation. Furthermore, we cannot and should not attempt to eliminate major market moves, whether by legislation or regulation. But we do need to ensure that our markets are configured in the best manner possible to withstand the increasing demands that are placed on them.

We should concentrate on ensuring the preeminent position of the United States' markets in an increasingly global marketplace. This is no longer a parochial tug-of-war between markets in New York and Chicago. Unless we manage and configure our markets correctly, we will not maintain our leadership in the global marketplace -- and this is one industry where once we fall behind, it will be very, very, difficult to catch up.

Mr. Chairman, that concludes my testimony. I will be pleased to answer any questions the Committee may have.

Senator **Dodd**. Thank you very much, Mr. Secretary.

You have made some interesting observations in your testimony, which I know will be the subject of a number of questions here this morning.

We have been joined by Senator Bryan, Senator Graham of Florida, and Senator Bond of Missouri. We thank you for coming by. If you have opening statements, they will be made a part of the record today.

We would like, with your permission, to move along with the questioning.

OPENING STATEMENT OF SENATOR BRYAN

Senator **Bryan**. I congratulate the chairman for calling this hearing on market reform which, I might add, he did well before the recent market crash. I am eager to hear the Secretary's testimony and what steps the administration is proposing to deal with market volatility. Clearly some reform is necessary to reassure small investors otherwise, they will stay on the sidelines.

The industry has taken action by implementing "circuit breakers" to help the market regain balance in times of volatility. I believe it is time for the administration to step to the plate.

As an aside, Mr. Chairman, I am finding the lack of initiative in this administration disturbing. We are waiting for the administration's plan for dealing with a number of critical issues ranging from HDTV to improving the U.S. savings rate. I have been willing to give them time to get personnel in place and review policies, but I believe the time to act has come. These are not the "Eisenhower years" when we could rest on our laurels.

The U.S. share of technology markets is eroding at an alarming rate. In 1980, we had 90 percent of the domestic color TV market, we now have 10 percent. We had 100 percent of the machine tool market, we now have less than 30 percent. No VCR or Facsimile machines are manufactured in the United States. I am all for "industry lead" consortium. The administration is relying on the industries themselves to rectify these shortfalls, and I am all for active industry participation. That is not, however, all that is necessary here. This administration needs to come up with its own concrete recommendations for addressing our trade and competitiveness problems.

Mr. Secretary, at yesterday's hearing on the condition of the banking industry, we had a lively debate on the competitiveness of U.S. financial services. There is a growing concern on this committee that we are seeing U.S. banks lose business at home and abroad. Japanese-owned banks now control about 25 percent of the banking market in California, and in the last 6 years, Japanese banks have according to the Wall Street Journal come from nowhere to become the leading providers of letters of credit. On the international front, several prominent American banks have recently retreated from Europe.

These dramatic changes are signaling a potential crisis in what has of late been our most competitive exports.

I commend the administration's efforts to combat trade barriers that U.S. financial firms are facing, but I am concerned that there is no coherent plan to address the eroding U.S. market share. I urge the administration to come up with a bold plan so that our financial services sector doesn't go the way of VCR's and machine tools. It is not yet too late.

Mr. Secretary, I hope we won't look back 5 years from now and say the United States lost the competition for the financial services on your watch.

Senator DODD. Mr. Secretary, prior to the events on October 13, there were some who suggested that the markets were just so strong that we simply did not need the Market Reform legislation that Senator Heinz and I introduced on behalf of the SEC.

As I read your testimony, and most importantly, your letter, which I deeply appreciate—I am going to ask unanimous consent that that letter be made a part of the record as well, because you addressed the legislation with some specificity there.

[Letter referred to follows:]

THE SECRETARY OF THE TREASURY
WASHINGTON

October 25, 1989

The Honorable Christopher J. Dodd
Chairman
Sucommittee on Securities
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

In response to your request, this letter provides the Administration's views on S. 648, "The Market Reform Act of 1989."

"The Market Reform Act" contains four proposals that the Securities and Exchange Commission (SEC) submitted to Congress last year to address issues raised by the market break. The SEC subsequently proposed a revised version of two of its provisions. The key provisions of the bill would:

(1) authorize the SEC to take certain actions in a market emergency;

(2) authorize the SEC to require large trader reporting of program or block trades;

(3) direct the SEC and Commodity Futures Trading Commission (CFTC) to facilitate linked or coordinated clearance and settlement of intermarket transactions; and

(4) authorize the SEC to require reports from broker-dealers concerning the financial or operational health of their affiliates.

We believe all four of these proposals are constructive and, with minor modifications, the Administration supports each of them. The stock market's 190 point decline on October 13, 1989, only serves to reaffirm their importance, especially the ones dealing with large trader reporting and risk assessment.

Volatility in the financial markets is likely to continue, and we must take steps to ensure that the markets can sustain themselves in turbulent conditions. The four proposals in S. 648 are timely and important -- the sooner they are enacted the better prepared we will be for future market volatility.

1. Emergency Powers

We support in concept giving the SEC emergency powers similar to those of the CFTC. In doing so we are aware that the SEC remains concerned that the provision could diminish Executive Branch control over the financial markets during emergencies. We disagree for several reasons.

First, this provision is necessary to enable the SEC to take emergency action without procedural delay in response to a major securities market disturbance. It is appropriate for the initial response to market emergencies to come from a regulator with expertise and proximity to the markets.

Second, the legislation already provides for some Executive oversight by allowing the President to terminate SEC emergency actions and requiring his approval of any trading halt longer than 24 hours (the maximum duration would be three days).

Finally, we also believe that language should be added to the bill requiring the SEC to consult with the President, the Federal Reserve Board, and the securities self-regulatory organizations (SRO) prior to taking any emergency action. This close coordination should help to ensure that emergency actions are not taken precipitously.

2. Large Trader Reporting

We are strongly in favor of large trader reporting to facilitate SEC surveillance and enforcement, including curbing intermarket front-running and market manipulation. Increasing the SEC's authority in this area also would make it more comparable to the CFTC's.

The October 13 decline underscores the importance of this provision as well. While the CFTC was able to reconstruct large futures trading almost immediately, the SEC was forced to collect data from member firms -- a cumbersome process that impedes the agency's ability to do its job effectively.

The Task Force on Market Mechanisms recommended establishment of a large trader reporting system for the securities markets similar to the one used in the futures markets. Although the Working Group on Financial Markets did not have a specific recommendation on this issue, Treasury did testify that strong agency and SRO action was needed to curb intermarket front-running and market manipulation.

Although we strongly favor enhanced SEC information in this area, we are concerned about the cost burden of collecting and reporting this information as well as its confidentiality. We suggest a provision be added to the effect that the Commission, in promulgating any rule, regulation or order, shall pay due regard to existing reporting systems, the costs and benefits of the additional information to be required, etc. Additionally, to enhance coordination the provision should require consultation with the CFTC as to any SEC rulemaking and permit disclosure of the reports to other agencies.

On May 17, 1989 the SEC transmitted to Congress a revised large trader reporting provision and section-by-section analysis. The revised section-by-section states that the SEC would:

- take into account relevant differences among reporting entities in establishing reporting requirements;
- take into account the adequacy of SRO large trader reporting requirements;
- make every effort to minimize the economic burdens and utilize existing data streams;
- carefully consider the costs and benefits of beneficial ownership reporting and not require broker-dealers to report such information if it is not recorded in the normal course of business; and
- carefully consider the impact on capital formation and the relationship between U.S. and international securities markets.

Although this is an improvement over the original section-by-section, we suggest that language be added to the legislation itself requiring the SEC to pay due regard to these factors, as well as to the need for confidentiality.

The SEC's revised version of the large trader reporting provision deletes futures reporting, and the section-by-section deletes a reference to CFTC consultation. We believe the legislation should require consultation with the CFTC as to any SEC rulemaking, even if futures reporting is deleted.

To the extent the large trader reporting provision would require reporting on government securities transactions, Treasury should have the rulemaking authority, consistent with Treasury's existing authority under the Government Securities Act.

We support the new language in the SEC revision authorizing the SEC to share large trader information with other federal agencies and extending confidential treatment of such information under the Freedom of Information Act (FOIA) to information received by those agencies.

3. Risk Assessment for Holding Company Systems

The risk assessment reporting provision contains the SEC's proposal enhancing the Commission's ability to assess the activities of firms associated with broker-dealers which may materially affect the broker-dealer's operational or financial condition.

The October 13 experience again points out the need for this authority, particularly during turbulent market conditions. We and the financial regulators spent much of the weekend after October 13 trying to find information on bridge loans and other indicia of systemic risk. This information should have been made available to regulators before it was needed.

We do have some concerns, however, about extraterritorial application of the reporting requirement and both its possible chilling effect on foreign investment in the U.S. and its implications for foreign regulation of U.S. firms. We would urge that the exclusions be codified to the extent possible (rather than leaving them to the SEC's discretion). This would include, for example: (1) the provision allowing the Commission to exclude from the reporting requirement any information regarding diversified holding companies and international financial organizations that do not devote a significant portion of their consolidated assets to activities in the U.S. financial markets; and (2) the provision allowing the Commission to consider the primary business of any associated person and the nature and extent of domestic or foreign regulation of the associated person's activities (perhaps excluding small broker-dealers, or not requiring information from primarily non-financial holding companies or major foreign banks).

Treasury should be given the rulemaking authority with respect to government securities brokers and dealers, consistent with Treasury's existing authority under the Government Securities Act.

We support the new language in the SEC's May 17 revision allowing the SEC to share such information with other federal agencies, notwithstanding FOIA, and extending confidential treatment of such information under FOIA to information received by those agencies.

4. Coordinated Clearing and Settlement

The bill would require the SEC and CFTC, in consultation with the Federal Reserve Board, to facilitate the establishment of linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities and related options, and securities derivative instruments. In addition, it would grant the SEC authority, in consultation with Treasury, to prescribe uniform rules concerning the transfer of certificated or uncertificated securities.

The Working Group on Financial Markets endorsed the view that the proper functioning of clearance and settlement systems is integral to the proper functioning of the financial markets as a whole. It concluded, however, that private market solutions, where feasible, are preferable to legislation in this area. The Working Group recommended a number of incremental actions which generally could be taken by federal regulators within the scope of existing authority, to increase security and clarity of clearance and settlement arrangements, enhance public confidence, and increase coordination. It identified initiatives that could be taken by the securities futures and banking industries to ease potential cash flow strains in volatile markets by reducing the size of payment obligations. It also recommended studies of more fundamental modifications.

Notwithstanding the Working Group's views (and subsequent Treasury statements in accord with them), we now believe that legislation is needed to speed up the process of refining and coordinating intermarket clearance and settlement.

Clearance and settlement is one of the most critical issues remaining on the Working Group's agenda from the 1987 market break, and it remains the weakest link in the system. Although the Working Group developed a very constructive set of recommendations, there has been enough progress in this area so far, which is especially important in the international arena. Improving clearance and settlement would reduce the risk that a securities market failure could become a credit market failure. It also would facilitate cross-margining in a more straightforward way.

A number of system refinements already are under way, for example the New York Stock Exchange/National Association of Securities Dealers commitment to implement next day comparisons and the Options Clearing Corporation/Chicago Mercantile Exchange joint cross-margining program. Useful studies have been completed or are in process, notably the American Bar Association task force on state laws and the Group of Thirty report in the international area. But more needs to be done, and without undue delay. Prompt and effective action on clearance and settlement is essential, and at this point "The Market Reform Act" seems to be the best way to expedite these critical improvements.

"The Market Reform Act" includes a provision that would grant the SEC authority to prescribe uniform rules concerning the transfer of securities. Because of the complexity of this issue, we believe this provision should be deleted from the bill until the matter has been given further study, and we encourage the efforts of the American Bar Association Task Force.

Finally, to avoid an overly expansive application, the Committee should consider deleting the word "centralized" from this provision so that consultation would only be aimed at facilitating "linked or coordinated" clearance and settlement systems.

Conclusion

With the modifications noted, the Administration supports this important legislation, and we look forward to working closely with the Committee as it considers S. 648 to assist its progress through the legislative process.

The Office of Management and Budget has advised that, from the standpoint of the Administration's program, it has no objection to the presentation of this report to the Committee.

Sincerely,

Nick

~~Nicholas F. Brad~~y

Senator DODD. You say the Market Reform Act would have been helpful—not that it necessarily had anything to do with what occurred on October 13, although I would be interested in hearing your observations on that—but it would have been helpful for those who are responsible for regulating the markets, over the weekend following October 13 for example.

I wonder if you might just give us you sense of the timing. Senator Riegle has indicated how important he thought it was for us to move on this piece of legislation. Is that your sense as well, that we should act pretty quickly?

Secretary BRADY. It is my sense as well, Senator. I think my answer does not indicate any heightened conclusion about the state of the market; but I think the four principal thrusts of the legislation are good, and we ought to enact them.

Senator DODD. Yesterday, Richard Breeden testified before the House Telecommunications and Finance Subcommittee, and they indicated that they by and large are in support of what we are doing here. To what extent are there any differences of opinion between you and the SEC?

Secretary BRADY. I do not think that they are ones that are sufficiently important that they need to be gone into this morning, Senator Dodd. We have some modifications that the Treasury staff and your staff and the House staff are working on, but I do not think that they in any way interfere with the basic thrust of the legislation.

Senator DODD. Could I just ask if it would be possible—and I would certainly go with our staff up here—and ask the Chairman if he would agree that next week we try to get people together to iron out whatever differences remain, so that we can actually schedule a mark-up; that we set a schedule so that we have some success in resolving those differences.

Secretary BRADY. That is fine.

The CHAIRMAN. Would you yield on that point?

I want to underscore my strong feeling, on behalf of what Senator Dodd has just said. The current intention is to try—try—to have the Senate adjourn on or about the Thanksgiving period. That may or may not come about. But I think whether it does or does not, the legislative window that is left for this calendar year, Mr. Secretary, is really quite short. I am talking about roughly a month's time.

My sense is, as Senator Dodd has said, that we can get this bill passed and on the President's desk this year. It is entirely possible and feasible to do that, but it will not happen unless we all put an expedited effort on it.

And I would like to just say again, I do not know that the differences that are outstanding now between, say, Treasury and the SEC, amount to that much. I do not know exactly what other sort of fine-tuning needs to be done. But I think, if we can have a formal process by which we get this ironed out in the next seven to ten days, I think we can report it to the full committee and take it through the Senate. I think the House will be agreeable with what we want to do here. And I think we can all have in place, before many more weeks pass, these steps and protections and items that can be helpful to us, particularly in light of the fact, as you have said, that no one knows what is ahead.

We are not assuming the worst, by any means, but let's have all of the tools and useful things we can have in place.

I want to pledge the cooperation of this committee to do this. We will put other things aside, to really work with you and the SEC. I suspect you may have to be the convener with respect to the non-Congressional side of this puzzle.

I think we can get this done, and I would really like to see us do it. I understand that you feel the same way.

Senator DODD. Thank you, Mr. Chairman.

You spent a few minutes in your testimony, Mr. Secretary, talking about the internationalization of markets. Senator Heinz and I held hearings earlier this year on that issue. That is an interest of mine, and I know an interest of the Senator from Pennsylvania. I am delighted to see you raise it to such a high level here in your testimony this morning.

Last year, you may recall, this Committee had a bill which did not pass, which would have created an Intermarket Coordination Committee, to deal with cross-market issues. I had drafted an amendment which was included in the bill, to have us look at the whole question of foreign financial regulators, and how we coordinate our activities with them.

Chairman Greenspan earlier this year indicated that he felt there was a strong need for greater coordination on the international front. I could not agree more with your statement that if we lose the advantage in this area we may never regain it. It would be years, if indeed we could ever really be successful at it.

I wonder if you just might share with us your outlook on the possibility of actually getting something done on the international front, and where you think agreement is likely and where you think it is probably not likely? Where should we be focusing our attentions, and what we can do to help in that process?

Secretary BRADY. Senator Dodd, I think in the international area the progress may be a little slower. Because, as you are well aware, we are talking about the SEC's and the Federal Reserve of foreign countries. We do not have the same ability to make action happen there that we do here. And there is, I know from my work on the G-7, a certain feeling that every country knows best what it should do.

So I think we should continue with an effort that has been made in the last two years, which is to increase the educational side of the equation; in other words, to get more of the same kind of facts out with regard to the international front, as we did for the Task Force's support in 1987.

There is no question in my mind that there is a greater interconnection these days than there was before, and it is the result of electronic data transmission and the way news spreads around the world.

I have told you this story before, but it is worth repeating. I happened to be in China at the Great Wall on the 16th of October, 1987. Someone came up to me and said, "The stock market has gone off 120 points." And I thought to myself, "My gosh, here I am in a bastion of Communism, and somebody has come up to me and told me something that happened on the New York Stock Exchange". So it brought home very clearly to me how the world has changed, and that information that previously could not go across borders, does. Of course, the same is true of the flow of funds.

So each person has their own example of how this has happened, but when we see the events live this recent Friday, October 13, the way we conduct surveillance and try to access the markets is not only by looking at our own markets, but by looking at what is happening in the London market, the Tokyo market, and the currency markets.

So it is very clear to me that the degree of internationalization continues to increase every day.

Senator DODD. Just to follow up on this—we saw the reactions on the Tokyo exchange and the London market during this past crisis. What steps, even informally, are being taken to try and coordinate?

Are there any conversations? Are there hot lines being established? What goes on to minimize getting a domino effect as you go around the globe 24 hours, so you do not end up exacerbating a market disturbance each time it makes a revolution.

Secretary BRADY. There are hot lines, not in the sense that there is a red telephone or anything like that; but the Treasury and the Federal Reserve keep in very close contact with Japan, London, and Germany, and other major exchanges around the world. Just on the weekend of October 13, I can assure you that between the Treasury and the Fed we had a number of conversations with people in those countries to assess not only the market activity, but the level of settlement and clearance worries that they might have.

Senator DODD. I understand that Chairman Greenspan announced over that weekend, as he had done in 1987, that liquidity would not be a problem. That was a very important statement for him to make. Were similar statements made by his counterparts in other countries?

Secretary BRADY. I cannot give you the answer to that question. You would have to ask Chairman Greenspan. I am not sure whether he made the statement himself, or whether that was a newspaper report. Perhaps it is more proper for him to answer that question.

At any rate, I know that the Federal Reserve in New York and the other capitals of the world were in contact.

Senator DODD. I just want to commend you for your interest in the international aspect of this, and to let you know that you have got some very willing players up here who would like to help in any way at all possible. A crisis could begin in some other market, and how would our markets react.

We have a tendency to think that the sun rises and sets in this country, but we could be affected dramatically by something occurring in another part of the world. So anything that can be done to help coordinate activities, it seems to me, is going to be extremely important.

My time has expired.

Senator Heinz.

Senator HEINZ. Thank you, Mr. Chairman.

Mr. Secretary, on page 3 of your testimony, you state that it is important to recognize that the stock market's decline on October 13th of this year does not signal any fundamental change in the condition of the economy, which in your view is well balanced.

That suggests the possibility, at least to me, that somehow the behavior of the market is disconnected or driven by factors that have very little to do with the underlying health of the economy. Now, that may not be the case, but if it is not the case, how does one explain that kind of apparent volatility in the market?

Secretary BRADY. Well, I do not say that it is entirely disconnected. But the point I was trying to make—and I will get to your question in a second, Senator Heinz—is that, in spite of the drop of 190 points, the economy looked as though we were going to have continued growth, and it was basically sound.

The question I think we all have is, how do you have a 190-point drop of the Dow Jones Average in an hour-and-a-half on volume of less than 250 million shares? And I think the answer is that there are—and again, we cannot be precise about exactly which—but there are market mechanisms which exist which produce that kind of a down draft.

In my opinion, one should not be terrified of this kind of thing. We simply have to deal with the new economic realities of electronic funds transfer, which is instantaneous, and of information which is instantaneous.

When it comes to a point where you get a lot of the same conclusions among a number of people who can exert big volume on the exchanges, it produces a down draft like we had on that particular day. So that is disconnected in my mind from the underlying state of the economy.

Senator HEINZ. A lot of us use the word "volatility," perhaps inaccurately, to describe what seems to be over the last several years the behavior of the market. Does Treasury have any studies as to whether or not the market today is in fact more volatile than the market of the good old days, whenever those were?

Secretary BRADY. I am sure we could provide you with some, Per se, I do not know of any.

By inspection, we have had in the last 20 years two 600 million share days, a loss of 22 percent in one day in 1987, and of course this year we had a 7 percent loss on Friday the 13th. So I would say that by inspection it is more volatile.

Senator HEINZ. I would be inclined to agree with that. But sometimes, when you go and look at statistics carefully, you find that the conventional wisdom—which I happen at this point to be guilty of, as well—is not necessarily supported by the facts.

Let's assume that the conventional wisdom is right. Do you share my concern that the volatility exacts a price on the economy in certain areas? My hunch is that, if you are a corporate treasurer, or a corporation trying to raise money, it causes a certain kind of problem for you.

My hunch is that the fact that there are demonstrably fewer individual or so-called small investors in the market is a signal that they have become frightened, whether it is because of the fear of coming after people who are front-running, or coming after people who have better technology and computer hook-ups. Those investors have been driven from the market.

Therefore, both the people you would want to come to the market, to raise money, and the people you would want to go to the market, to help supply it, are indeed casualties. There is a very real cost to the system from that.

Is that true?

Secretary **Brady**. I would agree that the individual investor seems not to be able to figure out how to deal with the phenomenon of volatility. The statistics indicate that he did leave the market after 1987. And although certainly there are some individuals who are back, the usual participation by individuals is not what it used to be.

Obviously, your point about treasury financing is that, if the market is see-sawing like this, it is hard to do.

Senator **Heinz**. Does that suggest, then, if there is less money for the people that need it, that the cost of capital probably has increased?

Secretary **Brady**. Well, one could say that, Senator Heinz. We do not have the statistical analyses that would prove it but that could be concluded.

Senator **Heinz**. It would be easier to prove that, just logically though. It would be easier, I suppose, to make a stronger case that the cost of capital is going up as a result of that, than going down.

Secretary **Brady**. I think that the volatility we have in the market is something that is difficult for a lot of people to comprehend.

I would only suggest that the work that has been done—not only by this committee but by the Treasury, the Fed, the SEC and the CFTC, since 1987, to lay out some of the facts as to how this happens—has produced an understanding of that process which I think had a good deal to do with the fact that the loss of 190 points on Friday, which was greater than the loss on a similar day in 1987, did not produce a corresponding down day on the following Monday.

Senator **Heinz**. The reason I am following this line of questioning is really this. I know you are very cognizant of the high cost of capital that America has, and it puts us at a competitive disadvantage in comparison to our major trading competitors.

There is, however, a school of thought in this country that says that it really does not matter that the cost of capital is differentially high in this country, and that all you need to offset that is a weaker dollar and everything will be fine. The weaker dollar will make our exports more profitable and people will put money into those enterprises because of the perceived profitability. Therefore, we should not worry about whether it is capital gains, or double taxation, or whether it is the volatility of the market, or any of the factors that cause the cost of capital to be high.

What do you say to that argument? This is a central argument against doing anything.

Secretary **Brady**. Senator Heinz, we have spoken on that very strongly, particularly in recent days, on the cost of capital.

Senator **Heinz**. But the question is, can't that cost of capital be offset by a weakening of the dollar, the exchange rate of the dollar, relative to other major trading currencies? If it goes down, some say that is good enough because it raises the cost of imports, and lowers the cost of exports. A weak dollar somehow makes the country better.

Secretary **BRADY**. I am not sure that is the case at all. I do not want to get into commenting on the level of exchange rates, because every time I do it produces turbulence in the market.

But I am not sure that a weak dollar would mean that the cost of capital in this country would go down.

Senator **HEINZ**. My time has expired.

Let me just say for the record, if I may, Mr. Chairman, to be very clear, this is not my point of view. The people who contend that a drop in the value of the dollar will offset the high cost of capital do not say that it reduces the cost of capital; they say it offsets the high cost of capital in terms of world competitiveness.

They argue that the reason you should not cut capital gains, or the reason you should not eliminate the double taxation of corporate profits and dividends, the reason you should not worry by extension about volatility of the stock market, and by extension the reason you should not worry about the educational system in this country which does not produce what it ought to, is that you can offset that with a weaker dollar.

Now, the reason I cannot accept that is that a weaker dollar carries with it some very high prices. It is called "inflation." Literally, a weaker dollar means that you have higher-priced imports, and in a global economy you pay for those higher prices because of the interconnectedness.

Therefore, I do not find that a very satisfying explanation. But I wanted your views. I have given you mine.

Thank you, Mr. Chairman.

Senator **DODD**. Thank you, Senator Heinz.

Senator Riegle.

The **CHAIRMAN**. It is very difficult to get into these complex subjects in the short time periods that we necessarily must work with.

I appreciate the quality of the statement today, and the fact that I think you have hit a number of things head-on. I appreciate that.

I want to get into the issue of the churning that may be going on in the market, the excessive trading activity that may be separate and apart from whatever the underlying fundamentals are.

Senator Heinz just raised the question of the contradiction on the one hand, that if everything seems to go pretty good in terms of the future, why does the market lose 7 percent of its value in roughly an hour's time? A very powerful question.

We have taken a look at some of the volatility statistics, trading volume statistics. Let me give you four or five, to try and put together in some kind of a composite.

Two years ago, in 1987, the turnover of all New York Stock Exchange listed stocks was 87 percent turnover in a single year. If you go back in time, that is roughly double what it was, say, in 1980. And if you go back as far back as 1960, it is five or six times higher. So there is a lot of turnover going on.

If you add the stock index futures, the total annual turnover rises to 150 percent. So you have got an awful lot of rollover of stock activity. When you take a look at who is doing it, the small investor has basically bailed out of the market to a very large extent, and the institutional investor is obviously a huge new force and growing force in the market.

The data that we have indicates that institutional investors account for 75 percent of all the trading, although they hold only about 50 percent of the shares. So if they behave in their trading practices the same way that individuals do, that by itself would reduce the volatility in just trading volume.

Pension funds represent 44 percent of institutional money, and are the single largest investor in equity markets. The data we have shows that the pension funds now earn 25 percent of all equities, and are going to be owning about 50 percent within 10 years. They already own half of all the shares of the nation's 50 biggest companies.

So if you take a look at who now owns the shares, and who is trading in the large volumes, we found this out. Between 1975 and 1983—and the data is somewhat out of date here, but I suspect it is even higher now—pension portfolio turnover tripled in just that period of 8 years.

What also comes out of the data is that pension funds that trade a lot and keep rolling these stocks over and adding to this market volume and volatility almost inevitably do worse than the market average. They trade more, and they end up doing less well than the market average. They end up eating up about a sixth of their portfolio income just in transaction costs.

So you have got this tremendous volume of trading activity out there, to which program trading and these other devices come along. They can accelerate, in my view at least, the way in which this is done. So you do a whole lot in a very short space of time, which can involve watching something like $250 billion of equity value vanish in a hour's time, as we saw on the 13th.

Now, these trend lines have been running for a period of time. They are very powerful trend lines. But it strikes me that as we start looking at this, we ought to think about some way to sensibly reduce just trading for trading's sake.

Now, I realize that this may offend my colleague from Texas, but I think there are some broader purposes served by our capital markets, in terms of maintaining their strength and soundness and long-term orientation and integrity, that require us to look at this.

I want to ask you specifically to react to one idea that has been presented by Senator Dole and by Senator Kassebaum. They have become concerned about this, and I share their concern. They have now proposed legislation that would impose a tax, an honest-to-God tax, on short-term gains of large pension funds which are not incurred to protect the long-term portfolio assets of the fund.

The way their legislation would work is that holdings of these pension funds of less than 30 days, if they are just rolled over and create a profit within that period of time, would be taxed at a 10 percent rate. Any holdings that are held for less than 6 months that are rolled over, the profits on that would be taxed at a 5 percent rate. When you get beyond the 6-month period, then they would not be taxed, as such. Gains from identified hedging transactions would be exempt from this kind of legislation.

Now, obviously, what Senators Dole and Kassebaum are trying to do here is to connect up all of these different things that seem to be going on at the same time: the loading up of shareholder power in the pension funds, institutional investors, the speed and the frequency with which they just engage in this roll-over activity, and the degree to which it is adding to volatility which seems not to carry with it much benefit. In fact, I think probably in terms of investor psychology, and other negatives we can identify without getting into a lengthy philosophical discussion, there are some real minuses associated with this in terms of the country's economic future.

What do you think of an idea like that? How do you react to the Dole-Kassebaum idea here as a way to structure a disincentive to stop some of the trading activity that does not seem to be driving any particular economic benefit for anybody?

Secretary Brady. Let me answer that question, but go back first to two things you said in the introductory part of your question, Senator Riegle.

First of all, the turnover rate has gone up to some extent. That is because the turnover has gone up and to some extent because there have not been very many new issues during this time. The supply of stocks, which would ordinarily increase, hasn't kept pace with the rate at which it increased in previous years.

I think there are two reasons why there aren't more new issues—one, that our Tax Code provides, as we have discussed before, a deduction for interest and double taxes on dividends. So water seeks its own level. That is an important factor.

The second factor is that the rate of return on common equity in the United States hasn't been sufficient to have people want to go out and sell new issues.

So those two factors I think have something to do with it, although they certainly don't vitiate the important point which you said.

Second, pension funds. I can never think about pension funds, as I know you don't, just as some group of funds that are sitting off to the side. They are the people of this country's savings, and so to the extent that we decry the disappearance of the individual investor, to some extent he is saving through pension funds and he is participating in the market through their involvement in the market as well.

So I take your point, but I also say that pension funds and other large funds, generally speaking, are the individual investor's way of coping with what he sees as volatility in the market, so his investment takes place in that way.

With respect to the Dole-Kassebaum legislation, I think it is worthy of a good deal of further study, and I can understand the concern that Senators Dole and Kassebaum have on this matter in the sense that pension funds' rate of turnover has increased in recent years, and of course they are not subject to tax.

At the same time, we also have to understand that these funds are a bigger part of the market, and do trade more frequently, which is the reason why we have the liquid markets that we do.

So if you were to go ahead and suggest—and I don't suggest doing so at this moment—that you want to put a tax on pension funds based on the length of their holdings, then I think you have to be prepared to study as well what effect that has on the liquidity of markets.

So I think that study ought to be made, and until it is made I really reserve comment.

The **CHAIRMAN**. Perhaps we can consider asking that something like that be done because I think the fact that that issue has now arisen on the other side of the aisle by serious people in a serious way, I think indicates that we ought to take a careful look at it.

Senator **DODD**. Senator Kassebaum is here. Senator Gramm I am going to recognize next, but we want to make that request of you. But Senator Kassebaum is one of the co-authors of the bill, and I want to give her an opportunity to raise some comments about that.

Senator **GRAMM**. Mr. Chairman, since I am sitting next to her—I feel that we have been studying this idea for 5000 years and have rejected it in the West, accepted it in the East. The outcome is pretty clear—if Mrs. Kassebaum wants to go ahead and go, I will wait.

Senator **KASSEBAUM**. You mean chivalry is accepted in the West?

Senator **DODD**. I think he is going to blast your idea, but he is going to be nice to you. [Laughter.]

Senator **KASSEBAUM**. That is why, my friend, I had rather follow you. [Laughter.]

Senator **DODD**. I think the Senator from Texas has been had.

Senator Gramm.

Senator **GRAMM**. So much for chivalry.

Well, thank you, Mr. Chairman.

In fact, in a very real sense we have been trying to debate at least one version of this idea in the Senate for several weeks. It is a version that has to do with the carrot instead of the stick.

The proposal that has been discussed here is to find a way to punish people who want to exercise their freedom to buy and sell at short intervals, which I thought was something of a Constitutional guarantee. But we have been debating this in a very real sense when we have been debating capital gains, because in debating capital gains we have been debating a way to provide incentives for long-term capital accumulation.

And I would like to ask the Secretary—give him some opportunity to put a good veneer over the previous comments—to comment on capital gains as a way of doing with incentives what the Senator from Michigan has talked about using the cold dead hand of authoritarian government to do. [Laughter.]

Secretary **BRADY**. Senator Gramm, I would be glad to. I know many Senators have heard my thoughts on capital gains, and I don't want to burden everybody with them again at great length, but we feel very strongly—and the President particularly feels strongly, going back to his own experience with the startup of a company that he was a big part of in his early days—that capital gains are a generator of growth, they are a producer of jobs, they are a producer of new products, they do lower the cost of capital in this country, and that it does make sense to have a differential between regular income and long-term capital gains if we are trying to orient people towards investing for the long term. To have one flat rate places no premium on sticking with an investment and producing the kind of results that we believe can only be made for the long term.

So I totally agree with the thought that you have advanced.

Senator **Gramm**. Let me ask you a question. Let me finally—since all of us on both sides of the aisle have talked about bigger, more momentous issues than this bill and in doing so we haven't been totally fair to the author of the bill, let me ask you a question about one part of the bill that I am concerned about. It is the question of the power to close a market.

I understand that the Commodity Futures Trading Commission Chairman has some market closing power. This bill proposes giving the power to close stock markets to the Chairman of the SEC, or to the whole Commission.

My feeling is that closing a market is so fundamental a thing, is potentially so traumatic—in fact, I believe that the October 19 collapse was to some degree related to a comment that was made by the SEC Chairman about closing the market. At least, that fed fuel to the fire. My own view is that only the President ought to have that power, and if the Commodity Futures Trading Commission has it, I would like to take it away from them, but I don't want to give it to the SEC.

And I wanted to get your views on that, Mr. Secretary. What do you think?

Secretary **Brady**. First of all, Senator, if you don't mind, I won't join you in trying to take it away from the Chairman of the CFTC. I will leave that job to you. [Laughter.]

However, of the four parts of this bill, I must admit I think that the section on the power to close the exchanges is the one that is not as important as others, but I do think we ought to grant that power to the SEC.

I see quite the reverse psychological effect that you do. I think if you have a Chairman of the SEC in conjunction with his other Commissioners deliberate and close the market, that is a lower level of involvement than if you had the President of the United States doing so. Even the speculation, during times of market turbulence, whether the President is going to or is not going to, and the nightly news forecasts conjecturing that this really won't happen, I think heightens the dramatic nature of that sort of a move.

So to a very real extent my feeling is that giving that power to the Chairman in conjunction with the full Commission really makes it less of a dramatic event and one that should be exercised at a level underneath the President.

Senator **Dodd**. Phil, I think I said something incorrectly to you when we were chatting informally about this.

As I understand it now, the CFTC Chairman can close down the entire market. The Chairman of the SEC can shut down activity on a particular stock.

Is that not the case?

Secretary **Brady**. I think that is correct.

Senator **Dodd**. What you are talking about here is the 24-hour window, I think, as well. If you go beyond that, it would require Presidential involvement.

Is that not also correct?

Secretary **Brady**. I believe that is correct.

Senator **Gramm**. Well, let me just conclude by saying that in my mind there are good arguments on both sides of this issue. My own view is that there is nothing more destabilizing than the inability to sell or the inability to buy, and that you are going to get two things that happen here, at least potentially.

One is that you are going to have, as occurred, for example, on October 19, when the stock market went down, the bond market went way up. We hit the trigger points. We shut down the trading of futures on government securities—on government futures. We shut down the futures market on government securities, and what happened is that the whole market shifted to London. They had a huge increase in volume, and markets continued to function. I think that really is the sort of evidence we have got to look at, at what is happening elsewhere.

Second, I think it is very important that we go back and look at what circuit breakers did on the 13th, because I am still not convinced that they helped. I view them as important when you have an inability to clear the market. I think that is vitally important, to stop, get your clearing caught up, and then start trading again. But when you expand capacity to clear, I just wonder, looking at the raw data—and I am no expert; you have them, Mr. Secretary—but I wonder if those trading pauses really promoted stability.

Thank you, Mr. Chairman.

Secretary **Brady**. We are studying that, Senator Gramm, and when we get the studies completed, we will certainly make them available.

My feeling, again, is that the circuit breaker was useful, but I haven't seen the data. It does give the human mind a chance to catch up with the speed of electronic communications, and maybe that is an old-fashioned thought, but it is one that stuck in my head.

Senator **Dodd**. Thank you, Senator. I will now turn to Senator Bryan. We are following the early bird rule here.

Senator **Bryan**. Fine. Thank you very much, Mr. Chairman. As a very junior member of the committee, I must say I appreciate the early bird rule.

Senator **Dodd**. As you spend more time here, you will not like the rule as much. [Laughter.]

Senator **Bryan**. I understand that is the case.

Mr. Secretary, I would like to focus attention, if I may, for a moment on LBO's.

My recollection is at the time of your confirmation hearing you expressed some concern about the level of activity of LBO's. Then just a little over a month ago in a speech before the National Association of Securities Dealers seemingly you changed your position and said you did not think that was a problem. Then about 28 days after that we had the October 13 episode in the market, which has been discussed here. Many people felt that the failure of the UAL leveraged buyout was a precipitating cause.

My question is today what is your sense, what is your feeling about LBO's? Is it a problem for us and, if so, what ought we do about it?

Secretary **Brady**. Senator Bryan, in spite of the fact that that may look like changing my mind, I haven't changed my mind at all. I said at the very first time I testified that I worried about the LBO phenomenon, and I challenged the people involved to use the great ingenuity and cash resources at their disposal to put the money to better use.

I also said at that time that we should look into the tax laws to see whether they were generative of any kind of excess activity in that area.

But underlying all of my thinking was the notion that this is a phenomenon that would not last, given the test of time, and I think that is exactly what happened.

My conviction then was that we will always have these bubbles in markets, going back to the tulip craze in Holland, and that if you let them play out they will bend of their own weight.

I think that is happening. I think to some extent that the events of October 13 reflected that. LBO's are harder to accomplish now. It is in the headlines of every financial section every day. The so-called bridge loans, which are a very big part of this process, are not being able to be put together. The junk bond market is no longer functioning the way it was. Congress has under discussion the PIK interest, which is a very important part of this.

I think that the LBO phenomenon won't stop completely, but in the sense we knew it a year ago it is going to be a thing of the past.

So my position is let the market work. Let's not put on the books legislation which would continue for 15 years afterwards. Let's see if the market will take care of this phenomenon.

Senator **Bryan**. Assuming for the sake of argument that we have reached a high water mark in terms of the activity, is it your view today that we need do nothing in terms of looking at the Tax Code or some other type of regulatory authority to enter into situations which might constitute a level of activity that might jeopardize the security or stability of the market?

Secretary **Brady**. Senator Bryan, I had advanced one initiative which is not possible at this particular time because of the budget strictures that we are under, and that is to examine closely the double taxation of dividends, which I am sure you are familiar with. So I wouldn't stop looking at that. The Treasury is looking at it. We haven't found a way to do it that doesn't produce revenue losses at this particular moment, but we will keep at it.

Senator **Bryan**. There are some who have suggested that we ought to take a look at the deductibility, at least in part, of the interest on the LBO's.

Would you favor that type of approach? If not, would there be a point in time at which the situation might be sufficiently exacerbated that you would be willing to consider that?

Secretary **Brady**. My opinion is that the situation won't be sufficiently exacerbated. I hope I don't live to eat those words, but it seems to me that the trend of LBO's is going to be down. Everything that we read indicates that.

I have felt that the problem with trying to define what is good interest and what is bad interest is that the definees are quicker to find a way around the law than the definor is to put a law in place. This happened in the 1960's and 1970's. It hasn't happened yet in the 1980's, but eventually the people who are involved in these businesses find a way around it.

So I think the truth of the matter is that we define something as we see it today, and pretty soon thereafter there is another way of looking at it, and, lo and behold, it has popped up again and the water is shooting out of another hole.

Senator **Bryan**. I don't think anyone would fault the free enterprise system for its ingenuity and imagination in developing new devices which circumvent rules, regulations, or Congressional actions that are designed to curb a particular activity, but as you know, the Ways and Means Committee had 26 or 27 recommendations that I recall that they were looking at as measures to curb the level of LBO's. The Administration took the position that with respect, I think, to about 24 or 25 of them—is there no recommendation that you would make to us at all? Are you simply saying that you think the problem has gone away, that we need not concern ourselves about it prospectively?

Secretary **Brady**. I can't adopt the words "let's not concern ourselves," Senator Bryan, but I think we ought to see what the market has produced in the way of a cure for something that I think you and I have agreed would be better if it wasn't happening. We have waited this long. I am perfectly willing to wait a little bit further because under the present conditions I simply do not see the level of this activity continuing what it was.

Senator **Bryan**. I suppose, Mr. Secretary, that some would respond to—and I would agree—that, as you suggest, that the financial journals of the country have focused a great deal of attention on that, and there does seem to be at least some lessening in the momentum.

But I think some might suggest that now, when we are in a state of relative equanimity with respect to the problem, might be the time to act rather than in a situation in which we may be in more of a crisis and responding as this institution is very famous for doing. When the crisis has hit it, some will say, well, the crisis has passed us by.

Secretary **Brady**. I understand the nature of your concern, which I share, and we are not unconcerned. I just feel at this particular point in time that events have overtaken the level of concern that we had in the past, and I think we ought to see whether the market itself makes this activity something we should worry about.

Senator **Bryan**. I appreciate your comment. I hope you are right because I think a lot of us see LBO's as something that is very damaging to the American economy and, frankly, has undermined our ability to compete internationally with a number of our major business enterprises, having been unable to sustain the debt load which has been incurred as a result of the LBO's.

Mr. Chairman, thank you very much.

Senator **Dodd**. Thank you very much, Senator Bryan.

Senator Kassebaum.

Senator **Kassebaum**. Thank you, Mr. Chairman.

Since Senator Riegle brought the tax disincentive on excessive churning up in the market, I might just respond to what Senator Gramm said about it because he said he thought to exercise their freedom to buy and sell at short intervals was something that we prized in this country, and I commented to Senator Gramm that I wish he could stay to hear my response to that.

This is the very thing that troubles me. It isn't their freedom. They are managers, pension managers of other people's money.

If you, Mr. Secretary, or I want to go in and out of the market five times a day, that is fine. That is our decision to make. But a pension manager is responsible for a large number of other people, and of course he has a responsibility to make money for that fund.

But he also has a larger responsibility, I would argue, to make sure that it is managed in such a way that it is going to provide stability for that fund, and it seems to me that what we have created in the marketplace today are games being played and the thrill of the risk that is involved, and I don't believe that is what really serves us well in the long term.

And as you have spoken, Mr. Secretary, and I think very wisely, to how we look at long term or short term, this was one of the ways that seemed to me to be one aspect of addressing it. I think you can even regard it, so to speak—I mean it is an excise tax—as a broker's fee, and any manager who would choose to want to go in and out of the market in 30 days or less would have to assume then they are going to pay 10 percent to do that.

But I think—and I certainly can appreciate wanting to look at all aspects of it—so often we tend to engage in legislative activity here without looking at the long-term consequences, and I value that observation that you made. I personally think it has some merit.

I guess that is more of a statement than a question, but going on just a moment, when we talk about rather than disincentives, perhaps incentives, either side of the coin gets expensive, but I know I have heard you speak and many others speak about what would be far more advantageous to financial conditions, would be if we could end the double taxation of dividends. But that is going to be at a cost that I have seen estimated at about $200 billion over four years, and I notice one of your advisers shaking his head.

But I would appreciate if there is some correction in that amount, that that is a figure that I have seen reported. This is a big cost. I don't know how we can do it at this point.

And I share Senator Bryan's concern when he speaks of the debt that has accumulated since 1982, I believe. $800 billion corporate debt has grown, and at the same time we have lost about $400 billion in equity, and I think that we all have to honor the consequences of the debt/equity ratio and what effect that has on us.

So I suppose my question to you is when you in your testimony said the bad news, participants, both institutions and individuals, have left the market in large numbers, is this because they are uncertain about the markets today, that there is some hesitancy that stability isn't there, that people are waiting to see what happens? How big a concern should that be?

Secretary **Brady**. Senator Kassebaum, you have raised a number of points.

First of all, I take your investigation of the pension fund matter as a serious inquiry, and we are looking at it as well. I do think you have to balance what it would do to the markets in terms of reducing their liquidity.

But with regard to people leaving the markets, I think a good part of it is that this phenomenon that we have seen starting in 1987 and again repeated in 1989 is hard for people to understand.

In trying to understand it myself, I think of an analogy. I think of it in the sense that we have had an enormous development in the speed with which information travels around the world and an enormous ability for people to make transactions instantaneously, Boom, boom, boom—they hit the key; their securities are bought or sold. That is completely different than it was 10 years ago.

Suppose we had one of these weather stations, which you see on television, tell us that two days from now we were going to have a 36-inch snow storm in Washington, D.C. and you had the ability to sit in your house and order from the supermarket all of the goods that you wanted at that particular point in time. Every supermarket from here to the southernmost border of Virginia would be out of goods because everybody would sit there and just order what they wanted, order more than they wanted just to make sure.

And the change that is taking place in the securities markets is no different from that, in my point of view. You can look at a weather map. You get that information instantaneously. If you have the ability like the securities markets now have and what we may have someday in other areas, if you can just go bang, bang, bang on your computer, you will have an enormous dislocation in the supermarkets in every part of the country—not in every part of the country, but in that part of the country where the snow storm was supposed to hit.

That, to my mind, is exactly what has happened with the securities markets. So we have to talk about what are the facts, what is the exact situation in these markets so people understand what is going on, and I think the level of discussion, starting in 1987, has become better informed—and I don't mean to brag on the Task Force report, but there has been very little correction in the facts that were put forward in that report. People now understand more and more about how the process takes place. They understand the relationship between Chicago and New York. They understand the enormous influences that not only Chicago, but international markets can have on our stock market. They have the idea in their minds that this is not a geographical problem any more. The market exists in a series of electron beams around the world, and the fact that they understand that I think to some extent caused them to view the loss on the 13th of October, which I might just state was greater than the lost on the previous Friday in 1987, with less alarm, and the market rebounded.

As I watched the computer, which had on it yen/dollar relationships, deutsche mark/dollar relationships, the fluctuations in the Japanese market, the fluctuations in the London market, the fluctuations in our own market and the Chicago market, you can see those forces washing around through those markets, and people were doing the same thing in various brokerage offices in capitals around the world.

They understood better, not perfectly but better, the interrelationship of those markets. So I think that that, to some degree, had the result of producing an increase on Monday.

So you say a lot of people have left the market. I think that that process, the understanding of that process, is very complicated, and it is very differential and it is slow in coming, but we are getting it understood. So I am hopeful that as people understand this process they will come back to the market.

Now, the volatility that still exists I think is a concern. There are two ways to combat it. One is to understand what it means and understand that it isn't some tidal wave gathering that is going to roll around the world and wipe out values, that it is this electronic magic that takes place. Or, we can look at some things like circuit breakers, like the proposals that are being made in S. 648, which will improve our understanding of the process, and I am hopeful that those measures will decrease the volatility.

But I can't tell you that it doesn't exist and it isn't something we are going to have to live with.

Senator **KASSEBAUM**. I would just say, Mr. Secretary, I am one who very much appreciated that task force report. I think it did provide a lot of food for thought and far greater understanding of the market, and I am supportive of S. 648 as well.

Secretary **BRADY**. You raised one further point, which was the cost of removing the double taxation of dividends. It is too big for us to deal with right now. I think the estimates we have are about $30 billion a year. So over four years it would be less than what you said. It doesn't make a big difference because we can't handle it right now anyway.

Senator **DODD**. Thank you very much.

Before leaving the point, you said, Mr. Secretary, there is an ongoing examination of this whole pension fund question which Senator Kassebaum has raised and that has been the subject of legislation. Maybe we could ask you to get back to us informally. I am not inclined to lay on agencies formal requests.

But if you are satisfied with that, Senator Kassebaum, in terms of an informal study to examine that question, then we might get that back at a reasonable time and take a look at that.

Senator **KASSEBAUM**. On the question of liquidity?

Senator **DODD**. Yes. I will make that request informally to you, Mr. Secretary, and ask you to deal with it on that level if you could.

Secretary **BRADY**. Fine. The Treasury does have an input on it. Certainly, the SEC, the CFTC and others do as well, and it should be given some thought.

Senator **DODD**. Let's see if we can't do something that will give us a better handle on that question. That would be helpful.

Senator Graham.

Senator **GRAHAM**. Mr. Chairman, the subject of my questions is going to primarily be in the global securities market, but I cannot restrain myself from making a comment on the pension question.

It seems to me the issue is not one of freedom or captivity for pension funds and their managers, rather that a special preference has been granted for reasons that appear to be good and sufficient, and that is that they would be free from taxation. So they not only have the ability to trade; they have the ability to trade without paying the tax that most other traders would have incurred in making a similar transaction.

So the issue now is to evaluate whether there are some unintended consequences, economically, socially, as a consequence of that tax decision which justify readdressing this issue, but it is not an issue of freedom. They will be free. The question is whether they would also be free and untaxed.

But my issue that I would like to discuss is in the global securities markets.

You mention on page 11 that this rapid expansion of global securities markets suggests that we should consider the interrelationships among markets on a global scale.

I note that while in several other areas of the legislation there are directives to either act or study as a predicate for future actions, there is not such a provision as it relates to the global securities markets.

Would you suggest any provisions that might be appropriately incorporated in this or other legislation that would facilitate the examination that you feel is necessary on the interrelationships of global securities markets?

Secretary BRADY. Senator Graham, I think we have to go a little slower here, not necessarily because it is not the right thing to do. We are talking about jurisdictions and regimes which are outside the purview of the United States Government.

When we are talking about the Japanese market, the London market, the German market, we are talking about foreign countries' business, and I think that there is already going on serious discussion among leaders of these countries as to how the markets interconnect, and they do interconnect. They not only interconnect because the same securities are traded both places; they interconnect because the level of currencies has a very real effect on the level of the markets. You can't look at stock markets any more these days without looking at currency markets at the same time.

So all of these things are interconnected. They are very complicated, in the sense that they cross boundaries in terms of having that discussion.

I would only tell you that there is a group called the Group of Thirty in London, which is studying this matter, with whom we have been in contact. There are discussions with other countries on the same subject.

So in terms of putting something in U.S. securities legislation, we are a little bit into the same problem as we are on money laundering. We want to get at it, but when you start telling a bank in Hong Kong they have to do such and so, you may find out that they don't agree with you.

Senator GRAHAM. I would agree that we probably are not at the step today to determine and place into statute what we ought to be doing, but I do feel that we are at the point that we ought to identify what the issues are and direct that there be a process which will get us to the point that we will have the right questions and a better basis upon which to answer them.

In some previous hearings on this subject, for example, it was stated that one of the differences between the United States and most of our major global securities trading partners and competitors is the fact that they are organized in a more focused regulatory scheme, so that there is somebody that you can sit down and talk to; whereas, in the United States, as your 1987 study pointed out, our regulatory system is a very diffuse system, and that could be an inhibitance to our effective participation in international discussions on securities issues.

Secretary **Brady**. Senator Graham, I am not sure I could agree that the other countries are more organized and focused than we are. It may be true in some. It is not true in others. They have the same division of authority as basically we do. It may not be four, like it is in the United States, but with two or three you have the same problem.

But your point—and I am not in any sense disagreeing with your level of concern. I think it is exactly on the right point. But we have to approach it a little differently because of the fact that we are dealing with sovereign countries.

Senator **Graham**. My request would be for some further thought on this issue, particularly toward defining what are the subquestions under the general question of global securities markets, with the intention that this legislation might be amended by adding appropriate study directives aimed at placing us in a better position, both for the Administration and for the Congress, to make some future judgments on how our national policy should be.

Secretary **Brady**. The so-called Working Group, Senator Graham, which consists of the Fed, the Treasury, the SEC, the CFTC, is working on this particular project right at this particular moment. So I think we are on our way to getting the kind of information you want.

Senator **Graham**. One final comment within that working group is that I would encourage some specific attention to the opportunities in Latin America. You have indicated that this is as much or more a bilateral relationship as it is multilateral. I believe that there are some special opportunities for an aggressive U.S. outreach in our own hemisphere.

Secretary **Brady**. Thank you.

Senator **Dodd**. Thank you very much, Senator Graham.

Senator Wirth.

Senator **Wirth**. Thank you very much, Mr. Chairman.

Mr. Secretary, thank you for being here. I have a number of quite specific questions that I wanted to address to you.

The first one goes to your testimony on page 12 related to margin requirements. Your discussion with Senator Kassebaum earlier talked about the weather map, and I get a sense of some changing weather here, and I wonder exactly what your position is on margin requirements.

You say in your testimony that in 1987—and I remember this—you thought that margin requirements ought to be harmonized. In 1988, the conclusion was that margin requirements were sufficient. You now say that you are concerned about margin requirements, that they ought to be readdressed.

What is the administration's position on margin requirements?

Secretary **Brady**. Senator, more or less just that.

Senator **Wirth**. You have got three positions?

Secretary **Brady**. It is a little different. The first statement you referred to is a statement in the task force report.

The second statement that I referred to was the conclusion of the Working Group, which is the interagency group here in Washington, that produced that result.

My testimony says that I feel we ought to reexamine the question again as to the level of margins, whether they are prudential, number one, and, number two, whether they are consistent between Chicago and New York, and we will do that.

Senator **Wirth**. The alleged Working Group was here in 1988. Mr. Gould, I believe, was the Chairman of the Working Group at the time. When I asked him about your recommendation that margin requirements be harmonized, he told us that the Working Group concluded that that was not necessary, that they looked adequate.

I don't see that any decision has been made on margin requirements at all. I see you did a good analysis, and I agreed with what you all came out with in 1987. The Working Group then backed off of that. You are now going to get the Working Group to look at it again.

Secretary **Brady**. That is correct.

Senator **Wirth**. How often does the Working Group meet?

Secretary **Brady**. At the staff level, it has been meeting on an ongoing basis. Since the appointment and confirmation of Mr. Breeden—I think it was about 3 weeks ago—the principals have met twice. So I expect the pace of the principals' meetings to pick up now that we have a Chairman of the SEC.

Senator **Wirth**. How often prior to October 13 did the group meet?

Secretary **Brady**. The principals?

Senator **Wirth**. Yes.

Secretary **Brady**. I would have to get you that information. I do not have it, but not too frequently because we didn't have a Chairman of the SEC.

Senator **Wirth**. There was a Chairman, though?

Secretary **Brady**. I understand, but it was in the sense that he was a lame duck. The meetings weren't going on.

Senator **Wirth**. Has the Working Group done anything other than the interim report in May 1988?

Secretary **Brady**. I can't give you the answer to that.

Senator **Wirth**. Why don't we get that for the record?

[Information follows:]

Working Group Accomplishments

As I stated in an October 18, 1988 letter to Chairman Markey, I am generally pleased with the progress of the Administration's Working Group on Financial Markets. Much of what our Presidential Task Force on Market Mechanisms ("Task Force") advocated has been accomplished by the Working Group through the constructive actions of the markets, regulators and self-regulatory organizations. The Working Group focused on the most significant suggestions of the Task Force and others that could be accomplished immediately to substantially lessen possible systemic dangers to the U.S. financial system if we were again to encounter a severe stock market decline.

The Working Group's efforts so far have focused primarily on: (1) continuing to meet periodically to address intermarket issues; (2) developing coordinated trading halts and reopenings, or circuit breakers, to avoid destabilizing market breaks; (3) reviewing and setting priorities for the enhancement of existing clearing, payments, and settlement systems; (4) encouraging efforts to bolster capital adequacy and overall trading system capacity; (5) encouraging the maintenance of prudential margin requirements; and (6) improving contingency planning by emphasizing procedures for better communication and information sharing across the agencies.

Most importantly, the Task Force's fundamental premise -- that the equity, futures and options markets are linked -- has been widely accepted. It is the basis for an important private sector initiative embodying the Task Force's and Working Group's recommendation of coordinated circuit breaker mechanisms: the joint plan of the New York Stock Exchange and the Chicago Mercantile Exchange to establish coordinated trading halts in their markets. As you know, the NYSE recently recommended a five-part program to curb excess volatility, and the CME has proposed certain modifications of its circuitbreakers.

In addition, the securities and commodities markets have made substantial progress on a number of other problems associated with the 1987 market break. For example, the securities markets have improved their computer and communications facilities. Progress has been made in the area of clearance and settlement, including the NYSE-NASD commitment to implement next-day comparisons. The New York Stock Exchange recently approved basket trading, which should facilitate index trading and diminish market volatility. The securities exchanges and over-the-counter market have increased specialist capital requirements, reallocated stocks from specialists where inadequate performance was identified, and improved execution procedures to ensure that market makers are reachable. The Intermarket Clearing Corporation and Options Clearing

Corporation have developed a cross-margining program allowing use of a single margin payment to support related futures and options positions. The Chicago Mercantile Exchange and the OCC also are making progress in cross-margining. The CME and the CBOT are working with the CFTC to develop "futures-style margining" of commodity options, which the exchanges believe will increase liquidity and efficiency.

These and other actions outlined in prior reports from the SEC and CFTC are the kinds of improvements the Working Group has been able to achieve in partnership with the regulators, SROs and market participants.

The market's failure to panic following the 190-point drop on October 13 underscores, I believe, the heightened confidence of market participants as a result of circuit breakers and other improvements that are now in place.

Another ongoing focus of the Working Group is the evolution of global electronic trading and enhancement of the international competitiveness of American financial markets.

The Working Group has formed a staff subgroup on circuit breakers which is reviewing the timing of release of government data on double- and triple-witching days, whether the circuit breakers need to be simplified, and whether the triggers should be adjusted. The Working Group also has established staff subgroups on clearance and settlement issues and contingency planning that meet from time to time as necessary.

Finally, the Working Group has set a constructive agenda for 1990, including exploring globalization issues, reviewing the performance of circuitbreakers, clearance and settlement issues, and a fresh look at margins.

The Working Group has made significant progress on the issues that are most crucial to the stability of the financial system. It has created a process for continued coordination, dialogue and cooperation, and I believe that process is working. I am confident the Working Group, together with the regulators, SROs and market participants, will continue to make improvements in market mechanisms throughout 1990.

Senator **Wirth**. The purpose of this questioning, Mr. Secretary, is, if one were to look at this, we have a feeling of a sense of drift. Maybe we are putting this off here, maybe putting this off here, decisions not being made, and we are all going to refer to the Working Group, but the Working Group really doesn't meet. Well, we didn't meet because we didn't have a Chairman of the SEC. There was a Chairman of the SEC. Now we have got a new one.

You don't get a sense, or I don't get a sense in answer to this that we are really joining these issues. That is my concern, and I wanted to get what your position was now on margin requirements.

The task force that you headed also made the following recommendations that "one agency should coordinate the few, but critical regulatory issues which have an impact across the related market segments and throughout the market system."

You were bragging a little bit on the task force report before. Maybe you would like to brag a little bit more on it again.

Do you still believe this is something that we ought to do?

Secretary **Brady**. I think that in light of what we have learned since that time, maybe the one agency coordination idea was written naively by somebody outside the government, Senator Wirth. But because we have a difference of jurisdictions between the CFTC, the SEC, the Fed, the Treasury, and several other agencies, I think we have to do the best we can in coordinating those activities.

I am not sure that that thought, which was a goal, is one that we should pursue today. I think there are certain areas where perhaps that should be the case. I think we are all well aware of the fact that in Chicago the futures markets are regulated by the CFTC, and yet the SEC regulates stocks. Yet there is a very intimate connection between those two instruments.

Now, if you are asking me whether you ought to pick up the CFTC and plop it into the SEC, I would say you are a much better judge of whether that is possible than I am.

Senator **Wirth**. I remember one agency should coordinate. That is the recommendation of the task force.

Again, your answer now is you don't think that that is necessary?

Secretary **Brady**. I don't believe that is a practical possibility, to answer the question directly. Based on what we have learned since 1987—you have to remember that that report was done some 60 days after the largest stock market collapse in the history of this country since 1929, perhaps we over-reacted to some extent.

But I don't think that that has lessened what we have learned since that point in time.

Senator **Wirth**. If I might ask you a third quite specific question related to program trading.

We have heard a lot of views of program trading here, but I don't think I have heard your view on program trading. We have seen an increase after the short decline after 1987 in program trading, and there has been a very sharp increase in those statistics.

Senator **Wirth**. What is your view now of program trading? Is this a threat to individual investor confidence? Is program trading a good idea? Is it ruining the market? What is your perspective?

Secretary **Brady**. Let me come back to program trading in a second.

But I think the volatility in the stock market is certainly a part of the reason why individuals aren't in the market to the extent that they were before. They do participate through pension funds and mutual funds where they feel that somebody who has more knowledge than they can cope with this volatility.

I can only say with respect to program trading—I hate to go back to my Weather Bureau and supermarkets example, but it is a concomitant, a result, in my opinion, of the electronic revolution that we have had. You can simply execute orders at a much greater rate because of the transmission speed at which funds flow, the speed at which information is exchanged, and the capacities of the Chicago market and the New York stock market, and after all, the stock market is a supermarket. That is where you go to buy the goods.

You have got that kind of a change in the system, which I think we understand better.

Senator **Wirth**. What is your view now of program trading?

Secretary **Brady**. My view of program trading is it isn't something that I personally would make use of in my own investing if I were doing that, which I am not. But if that is a tool that pension funds wish to use, then we have to understand better what effects it has on the market.

Senator **Wirth**. Should there be any administrative action to limit on program trading? What do you think we ought to do? You wouldn't do it personally, but what is your view on what the government should do? What is your responsibility as a steward?

Secretary **Brady**. I don't know at this particular time what we ought to do. I will say that it is not perfect yet.

Senator **Wirth**. Excuse me?

Secretary **Brady**. I do not have a view as to whether we ought to do anything about program trading at this point in time. I do feel that if program trading had a big effect on what happened on the 13th of October we understand better what that efficiency of markets means to the volatility of markets.

At least one point you can say that this is a tool which pension funds and other large investors, most of them tax-free, use to effect transactions.

Senator **Wirth**. I know how they are used. I just wanted to get your view.

Secretary **Brady**. Please let me finish one more second. Because their point of view is that they do that at a much cheaper cost to the investor, and they say that that cheaper cost is passed on to the pensioners and other participants, and that is the value that is produced. At the same time it produces this volatility.

Senator **Wirth**. A final specific question. Is our market overly dependent upon Japanese lenders?

Secretary **Brady**. I don't think so.

Senator **Wirth**. There are a lot of people who believe that the amount of money that the Japanese have invested in leveraged buyouts and the commitments that are outstanding are even greater. I understand, has led significantly to what happened on Friday, the 13th.

What do you think of that?

Secretary **Brady**. The Japanese have been a factor in the financing of leveraged buyouts, but before then it was somebody else. So I don't see that particular concern with that country as being part of the puzzle.

Senator **Wirth**. Thank you, Mr. Chairman.

Senator **Dodd**. Thank you, Senator Wirth. Let me follow up on a couple of questions if I can, Mr. Secretary. I would like to pick up on some thing Senator Wirth has raised with you.

I think we are all aware of the political practicalities that we may face in trying to move toward a single agency assuming responsibility here, but I also heard by implication your suggestion there that if it were not for those political impracticalities that substantively it would make some good sense.

Am I correct in hearing you?

Secretary **Brady**. Senator Dodd, I don't want to be flip in answering your question, but I don't think much about it any more because I don't think it is quite as necessary as we thought it was in 1987.

And, two, I wouldn't know what to do about it even if it was right, and I don't know that it is right.

What we really suggested and had in mind in 1987 was that the Federal Reserve had responsibility for margins on the New York Stock Exchange, and with regard to options on the New York Stock Exchange we thought it perhaps would make sense to coordinate that with the market in Chicago.

So it was really expanded out from that thought, and I think we have got a variety of possibilities in terms of what can be done.

Senator **Dodd**. Let me ask you as well about the individual investor. I had the statistics in front of me a while ago. Individual investors have retreated substantially since October 1987 and have really not come back, and I suspect that the activity on October 13 has not been a source of encouragement.

How worrisome is that? Are we talking about, as I've said before, the way of the American family farm? Is there nostalgia involved here, or is there something, in your view, that is extremely important?

It has been argued that individuals provide stability and liquidity to the markets. We are now replacing them with institutional investors and there are a lot of questions that that poses.

But how important is it? You know, are we sort of engaging in and reveling in the days gone by—days it would be ridiculous for us to try and have over again with internationalization of the markets and the need for massive amounts of capital. Would what you would have to do to lure the individual investor back be so detrimental to innovation in these markets? Is it worth it?

What is your sense of that?

Secretary **Brady**. I think we don't have to take Draconian actions in order to deal with the volatility problem. Some of the measures that are recommended in S. 648 will help. I don't think of those things that you suggested in the legislation as being anything but good sense. I don't think we are going to be involved in burdensome regulation and that sort of thing, and I think that will help to convince the small investor that we are on the way to assessing this problem.

I do have to say, when you have as fundamental a change as we have had in the electronic revolution, we don't realize what that means for some period of time. But we are starting to know, and I don't want to be repetitive, but the fact that the market recovered some of its losses in this last sell-off on Friday between Friday and Monday means that people do understand, and I hope that the individual investor will take cognizance of that.

Having said all of that, Senator Dodd, I think you are onto something that I certainly feel, which is an emotional thought—that this country was built by the efforts of small investors, and I feel offended, as does everybody else, when they aren't accorded some sort of special treatment which would encourage them to invest in the market. But at the same time, time marches on, and they are able to invest in mutual funds and pension funds.

So I don't know that it is the end of the world. I don't like it, if you are asking my personal opinion. I am not totally clear yet, as your statement would indicate, as to whether that emotional appeal, that emotional feeling, could be translated into some specific actions to do something to correct that.

I think if we have another correction and we again have another bounce-back, maybe people will say, well, that is what happens in this day of electronics. And I do recommend the analogy with the supermarket and the snow storm. Just imagine, if we had a snow storm coming and we could order by computer, what the shelves of the supermarket would look like—empty.

Senator **Dodd**. You are getting that now, I guess, with cable television.

Secretary **Brady**. It may be slow in coming.

Senator **Dodd**. I was struck when you talked about the new issues. We have seen a substantial drop in new issues since the fall of 1987. You answered that by saying, well, one of the problems out there is the double taxation on dividends.

The question I asked myself immediately when you said that was, well, we haven't had anything but that for a long, long time. It isn't as if we eliminated double taxation of dividends and then imposed it, which I would think would make the case.

But in the absence of that being around, isn't there some other reason going on other than that?

Secretary **Brady**. There are other reasons. I would only say that our major competitors do have tax rationalizations that don't double-tax dividends. However, I think one of the reasons why that has been around for a long time really is that the generation of people who dealt with the Depression in 1933 are no longer at the controls of major corporations and/or lending authorities, and our preoccupation with having too much debt as a nation isn't what it was 30 years ago.

We have a generation of younger people since the War who have more or less enjoyed a level of economic growth that is impressive, and of course in the last 85 months we have had continuous economic growth. So the people who borrow money in corporations are less worried about debt than they were before. So to fund their investment plans they are willing to borrow more than they were before, and lenders who wouldn't lend it to them before because their debt ratios got so high have changed their way of looking at debt. They don't feel it is as burdensome as it was before.

Maybe that is true. I certainly hope so.

Senator **Dodd**. I am sort of convinced that one of the major problems, although not the exclusive problem, is the low savings rate in this country. It seems to me you can do everything else correctly, but if you haven't encouraged savings in this country, then the cost of capital will be higher—just looking at the differential in the cost of capital in Japan and the cost of capital here, the studies that Merrill Lynch and others have done. It just jumps off the page at you.

We now know as well—and I am drawing you a bit into a discussion of IRA's because I think the question of savings is so important in terms of new issues and the liquidity of the market.

I know now that Bob Packwood is talking about IRA's as a way of encouraging savings. I think it was the Merrill Lynch study showing total IRA contributions between 1982 and 1986 of $172 billion. One of the criticisms of IRA's during the debate over the 1986 Tax Reform Act was that we were just shifting savings around—that IRA's didn't generate new savings. Now, the Merrill Lynch study claims that $138 billion of the $172 billion was new savings. In other words, IRA's really worked in terms of increasing savings in this country and, I would suggest, reducing the cost of capital. Wouldn't that be a major step for us in terms of this whole question of new issues?

Secretary **Brady**. I think it would, if you are talking about increasing our savings rate—is that the question?

Yes, I think it is a matter of enormous concern. I am sorry to say that our major international competitors around the world are not unmindful of the fact that their cost of capital is less than ours. The cost of capital has the same effect on the price of a product as the cost of any other raw material. So if it is lower elsewhere, the foreign competitors are going to be better able to take our markets, and the sorts of things that we have talked about, such as capital gains, double taxation and the removal of the biggest dissaver of all, which is the deficit, I am inclined to think that we ought to be working on and working on hard.

Senator **Dodd**. If we had to prioritize them—and maybe let's do this—wouldn't savings rate come as number one, in your view?

Secretary **Brady**. It would in my mind. I think, Senator, there is one other thing, and I only mention it because it entered the discussion, that the baby boomers who were consumers have now reached a level in their family lives where they have more of their disposable income to save, and there is some beginning evidence to indicate that the baby boomers are now beginning to save and that the reason for the upturn of the savings rate which has taken place in the last 6 months is that the baby boomers are now beginning to save.

So we may have the factor of demographics on our side.

Senator **Dodd**. I wanted to move into another area, but let me turn to my Chairman, who has been so patient with me. Chairman Riegle, do you have further questions?

The **Chairman**. Just a couple of points I would like to raise. Thank you, Chairman Dodd. Secretary Brady, there are two things I would like to get your answer to.

One is we are all aware of some of the big investment houses that have decided they are going to come back and have come back, to do program trading for their own account, and they become very substantial additional forces on the margin. Because they are in the markets, close to the markets, they have got a lot of capacity to affect volume activity.

Is it a good idea for the big investment houses to be back into trading for their own account?

Secretary **Brady**. Senator Riegle, I can't answer that question. That is a decision for the individual trading accounts and investment banks to make for themselves. I would only say that the considerations they have to take into account include whether they think they are customers or not.

The **Chairman**. Let me rephrase it. I don't really mean for you to try to assess it in terms of whether it is good for them to do it. I was looking at the broad public policy impact and the broad market impact.

In terms of the fact that we have got a lot of problems in the market—and you have illuminated a lot of them today in your statement, which I think has been very direct and to the point—as you throw that onto the mixture as one more item, is this helping us in the broad public policy sense, the market stability sense, the volatility sense, or is it contributing to the problem?

Secretary **Brady**. I don't think you can separate out program trading for the account of investment banks from program trading as a whole, because I am not sure it is that big a piece of the puzzle.

I think I gave my opinion on that question before. I would only add that I was going to continue to say that the individual investment banks have to decide whether their customers and clients or the market as a whole think this is a good idea.

I don't see legislation, and I know it is not suggested in this bill at this point in time.

The **Chairman**. As I am sure you know, the Kemper Financial Services, just as one outside financial entity, decided that they don't want to trade through companies that do that. You probably saw that in the newspapers.

Secretary **Brady**. Yes. I think, sir, if I may interrupt, that is kind of the market's answer, kind of an answer to your question for both of us in a sense, that a number of these big institutions such as Kemper tell the major investment banks they are not going to deal with them. That has got to have an effect on them. Unfortunately, that happened before—after the 1987 collapse. I am not sure whether it had a large effect or not.

The **Chairman**. My other question is this, and it goes to the question of investor confidence. The small investor is just getting mowed down in the market the way the market now seems to work.

Let's take a person who is a retiree, 65 years old, may have a modest amount of capital to invest in some form, say $10,000 to $15,000.

Do you think that person today with a high degree of confidence feels that they can come into the stock market in the face of all these other forces, in the face of program trading and electronics and all the big shooters and the rapid ups and downs? Is that person really well-advised if they have got a small nest egg to come in on their own as an investor in common stocks today?

Secretary BRADY. Senator Riegle, I think I have tried to answer this question before. People look at it in all different ways. If you had come in after the market collapsed in 1987, you would have made a lot of money since then.

However, I think that the individual investor doesn't know how to deal with this volatility that you are talking about. However, he does invest in the market through mutual funds and pension funds. So——

The CHAIRMAN. Are we forced to come to that conclusion, that the small investor today is now in a game that is dominated by other forces so in effect they have got to come through in proxy form in a mutual fund or a pension fund?

Secretary BRADY. Again, I repeat what I said before, which is that as we understand more of this process, people are not going to jump to the conclusion because we have one of these big swings that the world is about to end or that it is going to continue. I think that may be one result we can read, at this time out of what took place in October.

In answering the question that way, I don't want you to think for a minute that I like it when the individual investor has withdrawn from the market. I don't. I feel that has been an important part of our country's past, and I hope it is a big part of their future.

In trying to deal with the volatility question, I think we have made some steps in the sense that circuit breakers have been introduced between Chicago and New York. I think that some of the things in this legislation will further give people confidence, and I am hopeful that over time we will know how to deal with this.

People who understand—and again I hate to use analogies, but the supermarket analogy is one that I think is important.

The CHAIRMAN. It is to a point, but the person out there, the individual investor who is out there today and who has got a nest egg and who like to invest in their country, they would like to protect their capital and maybe increase their capital prudently over time. Suppose they are trying to decide what they can do and find if there is a place for them in this market. Suppose They are asking a question and they are asking it to me.

And the supermarket analogy really doesn't work all that well in terms of giving them an answer as to whether the market system, the way it is working now, is really a place in which they can come in on an equal footing or on a footing that really doesn't put them at a major disadvantage.

You know, they looked at it in large numbers themselves. They are netting out that they really can't come in and function with the way the system is working today. I guess the question that is left for us to ask as public policy people, is do we have to make a public policy judgment based on what we are seeing and to decide whether some changes are needed here beyond what has thus far been done that perhaps create an opportunity for that person?

Otherwise, I think we have to be straightforward enough to recognize that the game has changed, and if it has to that extent, then maybe we ought to be very forthright in saying to people you had better be very, very careful and don't assume that if you get in here you are not going to get run over by somebody that is going 200 miles an hour.

Somewhere along the line there is a public responsibility that attaches to those of us who are trying to make sense out of these sweeping changes to help the public be in a stronger position to be able to know what it is they are dealing with so they are not hurt.

Secretary BRADY. I think, not to disagree with you, but to add another dimension to what you say, that the individual investor is generally a long-term investor.

The CHAIRMAN. That depends. I used the example of somebody 65. Now, I suppose that is a long-term investor, too, but their situation is obviously different from a 25-year-old or a 30-year-old or a 35-year-old. Everybody is in and out, you know. My example was designed to take someone who wouldn't necessarily have a 40-year planning horizon.

Secretary BRADY. I was really thinking even something shorter than that, 10 years, 12 years, 15 years. I think if the individual investor does invest for the longer term, I don't think we should so paint the picture—and I know you are not, Senator Riegle—to say that the individual investor isn't in the market.

I still believe that over 50 percent of common stocks in the United States are owned by individuals. We made that conclusion at the time of the task force report. We haven't done it again, but I think that is the case.

So I was going to stretch my supermarket analogy further, but I won't.

Senator DODD. Just to pick up on what Don is saying, I sense with your comments as well, I have heard people sit at this table here and say, individual investing is a thing of the past, forget about it. You guys ought not to waste your time up there worrying about whether or not they are in or out. It is eventually just going to disappear.

And I am not that old. I was sort of shocked that someone would suggest that, and I thought, well, maybe I am engaging in nostalgia or something. Maybe fast, modern thinkers like our colleague from Texas ought to applaud that, but it bothers me, and I don't think any of us know really the answer to that.

I think we ought to spend some more time thinking about it because I am sort of sympathetic to what your reaction is—and I gather you don't want to fall prey, as you say, to nostalgia—and really analyze whether or not this ought to be something we maintain for the stability and liquidity of the markets.

You have been terrifically patient.

Senator Wirth.

Senator WIRTH. Thank you very much, Mr. Chairman.

Let's go back very briefly to our earlier discussion.

I understand how complicated these issues are and how frustrating they are. It is very hard often to get a handle on them, and I am not suggesting any kind of venality in not getting or having a clear answer to some of those questions.

I think it is important as one of the major starts, Mr. Secretary, is this legislation, and I think your statement at the bottom of the first page of your letter supporting the legislation and the need to move out very smartly on it—"The sooner they are enacted, the better prepared we will be for future market volatility"—is a very welcome one for this committee.

I note in your letter that there are a couple of areas, one at the top of page 2 and one on risk assessment on page 4, in which you do have problems with the legislation and some coordination to do with the SEC.

Will we get back in a time frame—I don't know if that, Mr. Chairman, is coming back from you all in the next eight or 10 days—a very specific set of comments on that so that we can move ahead and mark up the bill?

Secretary **Brady**. I believe we are working on that right now. Certainly, you should be entitled to a comment from us shortly.

Senator **Dodd**. Our intention is, as I heard the Secretary—and I was going to close on that point—that our staffs might even talk this afternoon, no later than tomorrow, to coordinate meetings beginning the first part of next week and, if necessary, with the SEC staff and the Treasury Department staff and the staff up here, to see if we cannot in whatever time it takes next week resolve those differences. Perhaps we can set a target date of the end of next week, if we work things out.

I have discussed this with the Chairman informally. That is my plan.

Senator **Wirth**. A couple of other items.

Senator Graham and I a few years ago picked up the proposal put together by Mr. Corrigan of the New York Federal Reserve that was focused on a variety of interests—one, modernization, and the second one looking at the payment system, and the third looking at the whole question of what we should be insuring. We put that in legislative form and introduced it.

Put aside for a moment the financial modernization issue, and I will come back and get your view if you have any thoughts on that.

The other two, I was wondering if we might have the Treasury and this Administration go back and look at Corrigan's proposals. There are some very interesting ones on the payment system of both our domestic coordination between the public and private side of that and how that relates internationally, and there were some very interesting ideas there on how broad we ought to be casting our federal insurance—two issues that we are going to have to come back to.

I was wondering if we might, Mr. Chairman, for the record make a request of the Treasury to get this Administration's position on those proposals.

Senator Graham and I introduced that two years ago and have always been enamored of many of the proposals made by Mr. Corrigan.

Senator **Dodd**. We might if you want to. I think at the same time I introduced the Bob Littan approach. That is a bit different. Part of it is financial services.

Let's make sure that we coordinate that. We will make that request of you, Mr. Secretary.

Senator **Wirth**. Finally, do you have any thoughts on what we should be doing—while we have got you here—what we should be doing on financial modernization of Glass-Steagall?

Secretary **Brady**. Well, Senator Wirth, the Treasury has a position which was stated last year on Glass-Steagall whereby we did agree that the Glass-Steagall legislation should be modified and changed. We are studying that again, but I can't tell you if there is any change in our position at this point in time.

Senator **Wirth**. Just that it ought to be looked at, but you don't have any specific recommendations that you would like to make on changes in the law?

Secretary **Brady**. I had rather we complete this review and get you an answer on that then. It hasn't changed enough to make any modification of our position, no.

Senator **Wirth**. Again, thank you, Mr. Secretary, for being up here. I don't want your being here to go without also a brief reference to the debt swap issue, which is something that you have paid attention to, which the Department has paid attention to.

As we look at the whole international debt question and the leverage that we have in the environmental world, there has been a lot of proposals made, some very interesting model programs done in the debt swap area. You have been sensitive to that and helpful on that, and I wanted to put in a word of thanks to you.

We are going to be asking you again to help us talk more aggressively to the World Bank, where I think we need more momentum than we currently have.

Thank you, Mr. Chairman.

Senator **Dodd**. We came here for 648, and we have covered the waterfront.

But we do thank you, Mr. Secretary.

Secretary **Brady**. I appreciate the opportunity to express our views.

Senator **Dodd**. Does that time schedule I outlined informally, does that seem acceptable to you?

Secretary **Brady**. I think so, yes.

Senator **Dodd**. Thanks. That will help us immensely to get this out.

The committee hearing stands adjourned.

[Whereupon, at 12:55 p.m., the committee was adjourned.]

[Additional material supplied for the record follows:]

The
Charles
Schwab
Corporation

TESTIMONY OF CHARLES R. SCHWAB
CHAIRMAN,
CHARLES SCHWAB & CO., INC.
BEFORE THE UNITED STATES SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES
PERTAINING TO THE "MARKET REFORM ACT OF 1989"

MAY 18, 1989

THANK YOU, MR. CHAIRMAN, AND MEMBERS OF THE COMMITTEE. I APPRECIATE THE OPPORTUNITY TO PROVIDE THIS TESTIMONY ON THE "MARKET REFORM ACT OF 1989", A PIECE OF LEGISLATION THAT TODAY, MORE THAN A YEAR AND A HALF AFTER BLACK MONDAY, ARGUABLY IS MORE VITAL TO THE NATIONAL INTEREST THAN EVER BEFORE.

WITH THE FINANCIAL MARKETS AND THE INVESTMENT COMMUNITY STILL TRYING TO COPE WITH THE AFTERSHOCKS OF BLACK MONDAY, YOUR CONSIDERATION OF THIS LEGISLATION TO MINIMIZE THE CHAOS IN A SIMILAR FUTURE MARKET SHOCK COULD NOT BE BETTER TIMED.

FOR, SENATORS, AS YOU DEAL WITH THIS BILL, COMPUTER-ASSISTED PROGRAM TRADING, THE GREAT WHITE SHARK OF WALL STREET WHICH CONTRIBUTED SO MIGHTILY TO THE CATASTROPHE OF OCTOBER, 1987, IS BACK AMONG US. CONSIDER THESE RECENT SIGHTINGS:

The Schwab Building • 101 Montgomery Street • San Francisco, CA 94104 • (415) 627-7000 • (800) 648-5300

-- ON MARCH 13 A FLURRY OF BUYING PROGRAMS CAUSED THE DOW JONES INDUSTRIAL AVERAGE TO SKYROCKET MORE THAN 30 POINTS IN THE FIRST HALF-HOUR OF TRADING.

-- FOUR DAYS LATER, A PROGRAM SELLING BINGE, COMPOUNDED BY THE TRIPLE EXPIRATION OF THE STOCK-INDEX FUTURES, INDEX OPTIONS AND INDIVIDUAL STOCK OPTIONS, HELPED DRIVE THE DOW DOWN ALMOST 49 POINTS.

-- DURING ONE WEEK JUST LAST MONTH, THE DOW ROARED AHEAD BY MORE THAN 72 POINTS AS PROGRAM TRADERS SOLD FUTURES ON THE MARKET INDEXES AND BOUGHT HUGE BASKETS OF STOCKS COMPRISING THE INDEXES.

INDEED, IT SEEMS THAT HARDLY A WEEK GOES BY WITHOUT NEW REPORTS OF MARKET SWINGS CAUSED BY PROGRAM TRADERS EXPLOITING EVEN MINUSCULE DIFFERENCES BETWEEN STOCK AND STOCK-INDEX FUTURES -- BUYING THE LESS EXPENSIVE, SELLING THE MORE EXPENSIVE AND POCKETING THE DIFFERENCE.

THE TERM PROGRAM TRADING USED TO BE ASSOCIATED WITH MUCH MORE BENIGN PROCESSES AT WALL STREET FIRMS, INCLUDING THE RESTRUCTURING OF A LARGE INSTITUTIONAL CUSTOMER'S STOCK PORTFOLIO OR THE QUICK LIQUIDATION OF A CLIENT'S TRUST. BUT SINCE THE ADVENT OF STOCK-INDEX FUTURES AND OPTIONS EARLY IN THIS DECADE, THE TERM HAS COME TO REFER TO THE SUDDEN SALES OF PURCHASES OF HUNDREDS OF THOUSANDS OF SHARES OF BLUE CHIP STOCKS, ARRAYED IN "MARKET BASKETS" CAREFULLY DESIGNED

TO MIRROR THE MAJOR MARKET INDEXES. AND THOSE SUDDEN SALES ARE TRIGGERED NOT BY DRAMATIC CHANGES IN CORPORATE OR ECONOMIC PROSPECTS, BUT SIMPLY BY PRICE CHANGES IN THE STOCK-INDEX FUTURES PITS.

JUST THINK OF WHAT THAT MEANS. STOCK PRICES ARE FREQUENTLY AND SYSTEMATICALLY BEING CAUSED TO GYRATE -- SOMETIMES WILDLY -- FOR REASONS THAT HAVE LITERALLY NOTHING TO DO WITH EITHER THE HISTORIC PURPOSES OF INVESTMENT OR THE DUAL ROLE OF THE STOCK MARKET AS A GUAGE OF THE VALUE OF U.S. CORPORATE ASSETS AND OF THE PROSPECTIVE HEALTH OF THE NATION'S ECONOMY. IN SHORT, SENATORS, THE RETURN OF WIDESPREAD PROGRAM TRADING, SPECIFICALLY, STOCK INDEX ARBITRAGE, PORTENDS INCREASINGLY DANGEROUS AND IRRATIONAL STOCK PRICE VOLATILITY.

EXCESS VOLATILITY HAS ALWAYS BEEN PERCEIVED AS A RISK FACTOR BY INDIVIDUAL INVESTORS -- OUR CUSTOMERS. THE AVERAGE OF OUR MORE THAN ONE MILLION ACTIVE CUSTOMERS IS A MALE, IN HIS LATE FORTIES WITH A HOUSEHOLD INCOME OF $50,000 to $60,000 A YEAR AND TOTAL INVESTMENT ASSETS OF LESS THAN $100,000. IN SHORT, HE IS THE TYPICAL AMERICAN INDIVIDUAL INVESTOR.

WHILE THIS INVESTOR IS PREPARED TO ACCEPT SOME PRICE SWINGS AMONG THE THINLY TRADED STOCKS OF SMALLER COMPANIES IN THE OVER-THE-COUNTER MARKET, HE LOSES CONFIDENCE WHEN BLUE-CHIP STOCKS ARE WHIPSAWED BY RAPID, COMPUTER-DRIVEN TRADING THAT HAS NOTHING TO DO WITH THE STOCKS' FUNDAMENTAL VALUE.

HE REMEMBERS ONLY TOO WELL HOW QUICKLY SUCH PROGRAM TRADING GOT OUT OF HAND ON OCTOBER 19, 1987, WHEN IT ACCOUNTED FOR 20% OF OVERALL TRADING AND AS MUCH AS 40% DURING BRIEF PERIODS OF THE MARKET'S TAILSPIN.

IN THE AFTERMATH OF THAT AWFUL DAY, THE BRADY COMMISSION AND OTHER GROUPS INVESTIGATING THE CRASH GAVE THE PUBLIC ITS FIRST INSIDE LOOK AT THE POWER OF INDEX ARBITRAGE AND RELATED PROGRAM TRADING STRATEGIES. AND THAT ATTENTION PRODUCED SOME POSITIVE RESULTS:

-- BOWING TO PRESSURE FROM INVESTORS, SEVERAL MAJOR WALL STREET FIRMS VOLUNTARILY WITHDREW FROM INDEX ARBITRAGE FOR THEIR OWN ACCOUNTS.

-- LAST MAY, THE NEW YORK STOCK EXCHANGE BEGAN MONITORING PROGRAM TRADING AND PUBLISHING THE RESULTS ON A MONTHLY BASIS.

-- LAST OCTOBER 19 THE BIG BOARD AND THE CHICAGO MERCANTILE EXCHANGE, HOME OF THE MOST HEAVILY TRADED STOCK INDEX FUTURES CONTRACTS, BEGAN A ONE-YEAR EXPERIMENTAL PROGRAM SANCTIONED BY THE SECURITIES AND EXCHANGE COMMISSION IN WHICH THEY STAND READY TO STOP TRADING AFTER SPECIFIED STEEP STOCK AND/OR FUTURES PRICE DROPS.

NEVERTHELESS, WHILE THERE WAS A SHARP DECLINE IN PROGRAM TRADING THROUGH MOST OF 1988, THE LULL PROVED TO BE ONLY

TEMPORARY. INDEX ARBITRAGE ACTIVITIES BEGAN TO PICK UP AGAIN DURING THE LATTER HALF OF 1988 AND IN DECEMBER, PROGRAM TRADING ACTIVITY ON THE BIG BOARD REACHED A POST-CRASH HIGH OF 12.6% OF DAILY SHARE VOLUME. ON SOME DAYS SINCE, IT HAS ACCOUNTED FOR AS MUCH AS 19% OF THE VOLUME.

THIS DANGEROUS REBOUND PRINCIPALLY REFLECTED THE INADEQUACY OF THE VOLUNTARY MEASURES TAKEN TO GUARD AGAINST EXCESS VOLATILITY. THE INVESTOR PRESSURE THAT PROMPTED THE MAJOR SECURITIES FIRMS TO SUSPEND PROGRAM TRADING FOR THEIR OWN ACCOUNTS EARLY LAST YEAR WANED AS THE YEAR DRAGGED ON AND WALL STREET'S POST CRASH BUSINESS SLUMP DEEPENED. EVENTUALLY, SEVERAL MAJOR FIRMS' HUNGER FOR TRADING PROFITS TO HELP OFFSET THEIR BELEAGUERED BROKERAGE BUSINESS OVERCAME THEIR SENSITIVITY ABOUT PROGRAM TRADING AND SO THESE FIRMS QUIETLY RESUMED THE PRACTICE. AFTER ALL, INDUSTRY-WIDE ANNUAL PROFITS FROM INDEX ARBITRAGE ARE ESTIMATED AT $150 MILLION OR MORE.

THE PILOT INTERMARKET CIRCUIT BREAKER PROGRAM SUFFERS FROM UNREALISTICALLY HIGH TRIGGER POINTS, TOO. FOR INSTANCE, UNDER TERMS OF THAT BIG BOARD/CME PROJECT, IT TAKES AN INTRA-DAY PLUNGE OF 250 POINTS IN THE DOW TO TRIGGER A MERE ONE-HOUR TRADING HALT ON THE STOCK EXCHANGE FLOOR. (THIS IS EQUIVALENT TO THE PERCENTAGE DECLINE OF THE ONE DAY CRASH OF OCTOBER 1929.) AND THE DOW WOULD HAVE TO FALL A 150 POINTS IN RESUMED TRADING ON THE SAME DAY TO FORCE AN ADDITIONAL TWO-HOUR HALT.

JUST AS THEY DID IN A SURVEY BY OUR FIRM SIX MONTHS AFTER THE CRASH, A WHOPPING 80% MAJORITY OF OUR ACTIVE INDIVIDUAL INVESTOR CUSTOMERS STILL BELIEVE THAT PROGRAM TRADING IS PRINCIPALLY RESPONSIBLE FOR THE VOLATILITY PLAGUING THE MARKETS AND THAT THEY'D THINK OF THE MARKET AS A SAFER PLACE IF PROGRAM TRADING WERE BANNED.

WHAT INDIVIDUAL INVESTORS THINK ABOUT THE MARKET MATTERS A VERY GREAT DEAL. THEY OWN MORE THAN 60% OF THE SECURITIES TRADED IN THE U.S. AND THEY ALSO ARE THE ULTIMATE BENEFICIARIES OF THE SHARES HELD BY INSTITUTIONS. SO, WHEN INDIVIDUAL INVESTORS RETREAT, CAPITAL BECOMES SCARCE. DURING THE FIRST THREE MONTHS OF THIS YEAR, ONLY $3 BILLION IN NEW EQUITY ISSUES WERE OFFERED TO THE PUBLIC, COMPARED WITH $8 BILLION IN 1987'S FIRST QUARTER.

NATURALLY, SUCH SCARCITY DRIVES UP THE ALREADY EXCESSIVE COST OF CAPITAL IN THE U.S. AMERICAN MANUFACTURERS, FOR EXAMPLE, PAY 50% TO 75% MORE FOR FIXED CAPITAL THAN THEIR COMPETITORS IN JAPAN.

FORTUNATELY, INDIVIDUAL INVESTORS HAVE BEEN RETURNING TO THE STOCK MARKET THIS YEAR, ALBEIT AT A CAUTIOUS PACE. TO KEEP THEM COMING, WE NEED TO ENSURE THAT INDIVIDUALS CAN PARTICIPATE ALONGSIDE LARGE INSTITUTIONAL INVESTORS WITHOUT FEAR OF BEING TRAMPLED DURING THE NEXT STAMPEDE TO LOCK IN STOCK-INDEX ARBITRAGE PROFITS.

THE MARKET REFORM ACT OF 1989 WILL BE A POSITIVE STEP IN THE DIRECTION OF PROVIDING THAT ASSURANCE. THE BILL'S PARTICULAR STRENGTH IS IN ITS ADDRESSING THE HIGHLY TECHNICAL, BUT VERY REAL, PROBLEMS OF

CLEARANCE AND PAYMENT IN THE FUTURES AND OPTIONS MARKETS, ON THE ONE HAND, AND THE STOCK MARKET ON THE OTHER. CLEARLY THE MOST FRIGHTENING PROBLEMS ENCOUNTERED ON THE DAY AFTER BLACK MONDAY -- WHEN THE NATION'S FINANCIAL SYSTEM CAME WITHIN A WHISKER OF MELTDOWN -- WERE CLEARANCE AND PAYMENTS PROBLEMS. AND IN MANDATING A RATIONAL INTERMARKET LINKAGE OF THESE PROCESSES, THE BILL SHOULD GO FAR TOWARD ELIMINATING THESE PROBLEMS.

SIMILARLY, AS I READ THE LEGISLATION, THE SEC WOULD BE EMPOWERED TO INTERVENE IN MARKET CRISES THROUGH TRADING SUSPENSIONS AND SUPPLEMENTAL REPORTING REQUIREMENTS. THIS, TOO, SHOULD GIVE INDIVIDUAL INVESTORS ADDED CONFIDENCE. BUT TRUTHFULLY, I MUST TELL YOU THAT YOU WILL MISS AN OPPORTUNITY TO STRENGTHEN CONFIDENCE FURTHER UNLESS YOU ADD SPECIFIC CONTROLS ON PROGRAM TRADING TO THE BILL.

FOR EXAMPLE I WOULD URGE YOU TO CONSIDER ADDING LANGUAGE TO THE BILL THAT DIRECTS THE SEC TO WORK WITH THE CFTC AND FUTURES EXCHANGES TO SET REALISTIC DAILY LIMITS ON THE AMOUNT THAT A STOCK-INDEX FUTURES CONTRACT PRICE CAN VARY FROM THE INDEX UPON WHICH IT IS BASED -- SAY A BAND OF 1% to 2%. IF THE LIMIT IS EXCEEDED, TRADING SHOULD BE HALTED FOR THE REMAINDER OF THAT DAY'S SESSION. IN THIS WAY, LEGITIMATE INDEX ARBITRAGE COULD PROCEED UNIMPEDED WITHOUT THE RISK OF THOSE BRIEF, CHAOTIC PERIODS WHEN VIOLENT SHIFTS IN BUYING OR SELLING WOULD CAUSE THE FUTURES AND STOCK MARKETS TO

TOTALLY DISCONNECT. THAT WOULD FREE THE STOCK MARKET TO FOCUS EXCLUSIVELY ON ITS ESSENTIAL ROLE AS A CONDUIT FOR CAPITAL FORMATION AND THE FUTURES MARKET TO CONTINUE IN THEIR ROLE AS MEETING GROUNDS FOR THE EFFICIENT TRANSFER OF RISK.

ALTERNATIVELY, MORE SPECIFIC LANGUAGE EMPOWERING THE SEC TO TEMPORARILY SUSPEND OR MODIFY THE RULES OF PROGRAM TRADING DURING PERIODS OF MARKET CRISIS WOULD ALSO STRENGTHEN THE LEGISLATION.

IF I SEEM PREOCCUPIED WITH PROGRAM TRADING, IT IS BECAUSE I AM CONVINCED THAT TO REGAIN THE CONFIDENCE OF THE INDIVIDUAL INVESTORS WHO REMAIN THE BACKBONE OF OUR FREE MARKETS SYSTEM, CONGRESS, SECURITIES REGULATORS AND THE INDUSTRY ITSELF MUST ACT QUICKLY AND DECISIVELY AGAINST THE DESTRUCTIVE ASPECTS OF PROGRAM TRADING. ADMITTEDLY SUCH ACTION MAY REDUCE BOTH FUTURES AND STOCK TRADING VOLUME -- ALONG WITH THE PROFITS OF A FEW INVESTORS. THE END RESULT, HOWEVER, WILL BE STRONGER AND BETTER MARKETS WITH BROADENED INDIVIDUAL-INVESTOR PARTICIPATION. AND BLACK MONDAY HAS SHOWN US ALL THAT THE ALTERNATIVE TO STRONG AND LIQUID MARKETS IN OUR AGE IS UNTHINKABLE.

END OF TESTIMONY

Opinion Research Corporation

Investor Attitudes Questionnaire

OPINION RESEARCH CORPORATION 64144
Princeton, New Jersey 050988

INVESTOR ATTITUDES
QUESTIONNAIRE

First, a general question.

1. Twelve months from now, do you expect to be better off financially or worse off than you are now?

76%	Better off
8	Worse off
12	ABOUT THE SAME
4	DON'T KNOW
*	NO ANSWER

* Less than 1%

2. Which of the following best describes what you expect stock prices to do in the next 12 months? (READ LIST. CIRCLE ONE ANSWER.)

3%	Strong increase
55	Moderate increase
13	No increase
19	Moderate decline
4	Sharp decline
5	DON'T KNOW
1	NO ANSWER

3. People get guidance from different sources when making investments. Whom do you place the most trust in for stock market advice? (READ LIST. CIRCLE ONE ANSWER.)

11%	Friends and relatives
12	Newspapers and magazines
3	TV analysts
4	Stock market newsletters
21	Stockbrokers
24	Your own analysis
4	Banks
19	Financial advisor
2	DON'T KNOW
1	OTHER

4. Do you agree or disagree with the following statements? (CIRCLE ONE ANSWER FOR EACH ITEM LISTED BELOW.)

	Agree	Disagree	DON'T KNOW/NO OPINION
a. The stock markets performed well under the difficult conditions of last fall	66%	28	6
b. The stock markets are now much riskier for the individual investor than they were 12 months ago	61%	34	5
c. Institutional investors dominate the activity in the stock markets too much	70%	16	14
d. In the wake of the stock market decline,- it is more difficult to have confidence in a stockbroker's advice	61%	33	6
e. The world's securities markets are evolving into a single global market	63%	18	19
f. Trading in stock index options and futures contracts has made it more difficult for the individual investor to understand what's happening in the stock market	81%	13	6

5. Many changes have been proposed following the October stock market decline. Do you favor, oppose, or are you neutral toward each of the following proposed changes? (CIRCLE ONE ANSWER FOR EACH ITEM LISTED BELOW.)

	Favor	Oppose	Neutral	DON'T KNOW/NO OPINION
a. Greater control over program trading by institutions	51%	18	24	7
b. Suspension of stock trading if the markets advance or decline too far or too rapidly	53%	23	17	7
c. Increase in margin requirements for options and futures trading	49%	12	23	16
d. Increase in margin requirements for stock trading	46%	17	23	14
e. Creation of a new regulatory body to coordinate regulation of the different financial markets	42%	34	17	7

6. Which of the following best describes your strategy for your current stock and stock mutual fund holdings? Are you ... (READ LIST.)

64%	Invested for long-term appreciation in stock value,
13	Invested for short-term appreciation in stock value,
9	Waiting for prices to increase so that you can sell and avoid or reduce a loss, or
18	Invested for dividend yields?
1	DON'T KNOW
1	NO ANSWER

NOTE: DOES NOT ADD UP TO 100% DUE TO MULTIPLE RESPONSES.

7. Have you bought any stock or stock mutual funds since October 1987?

51%	YES
48	NO
1	DON'T KNOW

NO / DON'T KNOW → SKIP TO Q. 9

IF "1" ON Q. 7, ASK:

8. What are the main reasons why you have invested in stock or stock mutual funds since October? (PROBE AND RECORD ANSWER.)

25%	To meet personal financial goals
15%	Low stock prices
15	Employer-sponsored investment plan
12	Long-term investment
11	Favorable market conditions
10	Expect gain (non-specific)
9	Income/dividend

9. Do you or other members of your household have any securities trading accounts -- either as individuals or jointly with another person -- where you can call and place an order to buy or sell stock?

41%	YES
57	NO
2	DON'T KNOW

NO / DON'T KNOW → SKIP TO Q. 13

IF "1" ON Q. 9 ASK:

10. For the accounts on which you make investment decisions, how many stock trades, that is, separate buy and sell transactions, have you, yourself, made in the past 12 months? Please exclude any purchases made on a regular monthly, or more frequent, basis. (DO NOT READ LIST. CIRCLE APPROPRIATE NUMBER.)

12%	ONE
11	TWO
7	THREE
5	FOUR
13	5 - 9
6	10 - 14
1	15 - 19
5	20 OR MORE
32	NONE
7	DON'T KNOW
1	REFUSED

11. How satisfied are you with the performance of your stockbroker? Would you say you are very satisfied, fairly satisfied, somewhat dissatisfied, or very dissatisfied?

33%	VERY SATISFIED
45	FAIRLY SATISFIED
12	SOMEWHAT DISSATISFIED
5	VERY DISSATISFIED
1	DON'T KNOW
4	NO ANSWER

12. During or since October 1987 have you ...

a. Made any written complaints to your stockbroker that still remain unresolved?

1%	YES
98	NO
1	DON'T KNOW

b. Experienced any delays in redeeming mutual funds?

3%	YES
96	NO
1	DON'T KNOW

13. Would you say that you are very likely, fairly likely, somewhat unlikely, or very unlikely to buy stocks or stock mutual funds in the next 12 months?

33%	VERY LIKELY
22	FAIRLY LIKELY
17	SOMEWHAT UNLIKELY
27	VERY UNLIKELY
1	DON'T KNOW

14. How has your investment strategy changed since the stock market decline in October? Have you become more aggressive, more conservative, or stayed the same?

4%	MORE AGGRESSIVE
39	MORE CONSERVATIVE
56	STAYED THE SAME
1	DON'T KNOW

15. Since the stock market decline in October, are you more likely, less likely, or about as likely as before to ... (READ FIRST ITEM.) (CIRCLE ONE ANSWER FOR EACH ITEM LISTED.) (ROTATE STARTING POINTS.)

	More Likely	Less Likely	About As Likely	DON'T KNOW/NO OPINION	NEVER DID THIS
a. Invest in common stocks	15%	40	41	3	1
b. Invest in stock mutual funds	22%	35	36	4	3
c. Invest in initial public offerings of stock	10%	57	20	8	5
d. Invest in large, well-known companies	40%	25	31	3	1
e. Invest in smaller, growth-oriented companies	19%	51	24	4	2
f. Invest in foreign stocks directly, or through mutual funds or ADRs	11%	58	18	6	7
g. Seek advice from a stockbroker before making investment decisions	35%	30	29	3	3
h. Buy stocks through a margin account	8%	56	18	10	8
15a. We would also like to find out about the changes in your personal spending habits. Are you now more likely, less likely, or about as likely to:					
i. Make a major expenditure such as buying a house, or car, or taking an expensive vacation	21%	36	41	2	0
j. Make an effort to save a larger proportion of your income	52%	13	34	1	0

16. I'm going to read you a list of things that might happen in the next 12 months. For each one, please tell me if it would make you much more likely to invest or increase your investments in the stock market, make you somewhat more likely to invest or increase your investments, have no real impact, make you somewhat less likely to invest or increase your investments, or make you much less likely to invest or increase your investments? First ... (READ FIRST ITEM.) (CIRCLE ONE ANSWER FOR EACH ITEM LISTED.) (ROTATE STARTING POINTS.)

		Much More Likely	Somewhat More Likely	No Impact	Somewhat Less Likely	Much Less Likely	DON'T KNOW/NO OPINION
a.	A significant decrease in the budget deficit	16%	27	32	11	9	5
b.	A significant decrease in the trade deficit	15%	27	33	11	7	7
c.	The dollar goes up in value	17%	31	31	11	5	5
d.	Restrictions on program trading by large institutions	9	22	39	13	8	9
e.	A major increase in stock prices	9%	19	28	25	15	4
f.	The dollar goes down in value	4%	11	32	30	19	4
g.	A significant increase in the budget deficit	4%	7	28	30	25	6
h.	A significant increase in the trade deficit	5%	9	32	28	21	5
i.	A major decrease in stock prices	16%	25	23	17	15	4
j.	The stock markets become less volatile, and there are fewer drastic ups and downs	19%	33	30	9	5	4

Next, we'd like to ask you a few questions about IRAs or Individual Retirement Accounts.

17. Do you have any money invested in an IRA?

57% YES
42 NO → SKIP TO Q. 24
1 DON'T KNOW → SKIP TO Q. 24

IF "1" ON Q. 17, ASK:

18. Recent changes in the tax laws have changed the tax deductibility of IRAs for some people, but not for everybody. Has the tax law changed the deductibility of your IRA?

51% YES
42 NO → SKIP TO Q. 24
7 DON'T KNOW → SKIP TO Q. 24

IF "1" ON Q. 18, ASK:

19. Has the change in the IRA's deductibility made you save less money overall?

48% YES
50 NO
2 DON'T KNOW

20. Has the change in the IRA's deductibility caused you to invest less in stocks?

30% YES
70 NO
* DON'T KNOW

The next few questions will deal with specific types of investments. No attempt will be made to sell you any of these investments.

21. Have you ever invested in an initial public offering of stock by a company that had been privately held?

27% YES ⟶ SKIP TO Q. 23
70 NO
3 DON'T KNOW

IF "2" OR "3" ON Q. 21, ASK:

22. Would you be interested in investing in initial public stock offerings if they were conveniently available?

27% YES
60 NO
13 DON'T KNOW

23. Have you ever invested in stocks of foreign companies, in ADRs of foreign companies, or in mutual funds that purchase stocks of foreign companies?

21% YES ⟶ SKIP TO Q. 25
76 NO
3 DON'T KNOW

IF "2" OR "3" ON Q. 23, ASK:

24. Would you be interested in investing in foreign companies if there were a convenient way to do so?

17% YES
75 NO
8 DON'T KNOW

25. Have you ever invested in a private offering of stock in a new company that was not yet publicly traded?

19%	YES → SKIP TO Q. 27
79	NO
2	DON'T KNOW

IF "2" OR "3" ON Q. 25, ASK:

26. Would you be interested in investing in private stock offerings if they were conveniently available?

28%	YES
58	NO
14	DON'T KNOW

27. What is the approximate current value of your household's stock portfolio? (READ LIST. CIRCLE ONE ANSWER.)

4%	No stock owned at present time
10	Less than $2,500
11	$2,500 but less than $5,000
14	$5,000 but less than $10,000
11	$10,000 but less than $20,000
15	$20,000 but less than $50,000
9	$50,000 but less than $100,000
6	$100.000 but less than $250,000
2	$250,000 but less than $500,000
1	$500,000 or more
9	DON'T KNOW
8	REFUSED

28. When did you first acquire stock or stock mutual fund shares? Was it ... (READ LIST. CIRCLE ONE ANSWER.)

2%	Since the beginning of 1988,
8	During 1987,
9	During 1986,
8	During 1985, or
72	Before 1985?
1	DON'T KNOW

29. Approximately what is the combined current value of the total assets owned by you and all other members of your immediate household? Please exclude the value of your primary residence. (READ CATEGORIES UNTIL RESPONDENT SELECTS AN ANSWER.)

5%	Less than $10,000
13	$10,000 but less than $25,000
17	$25,000 but less than $50,000
19	$50,000 but less than $100,000
14	$100,000 but less than $250,000
8	$250,000 but less than $500,000
3	$500,000 but less than $1,000,000
2	$1,000,000 or more
6	DON'T KNOW
16	REFUSED

30. For statistical purposes, we need to know your household income for 1987. Please indicate your total household income for 1987, before taxes. Include your own income and that of any members of your immediate household who are living with you. (READ LIST UNTIL RESPONDENT SELECTS AN ANSWER.)

1%	Less than $10,000
11	Between $10,000 but less than $25,000
33	Between $25,000 but less than $50,000
29	Between $50,000 but less than $100,000
6	Between $100,000 but less than $250,000
1	Between $250,000 but less than $500,000
*	Between $500,000 but less than $1,000,000
*	$1,000,000 or more
3	DON'T KNOW
16	REFUSED

31. **Are you currently employed outside of your home, either full-time or part-time?**

62%	YES, FULL-TIME	▶SKIP TO Q. 36
8	YES, PART-TIME	
30	NO, NOT EMPLOYED	

IF "3" ON Q. 31, ASK:

32. Are you currently retired, a homemaker, a student, or out of work?

49%	RETIRED
41	HOMEMAKER
5	STUDENT
4	OUT OF WORK
2	OTHER (Specify):____________________
*	REFUSED

SKIP TO Q. 37

IF "1" OR "2" ON Q. 32, ASK:

33. What is your occupation? (PROBE And RECORD ACCURATELY BELOW.)

WRITE IN:________________________________

OFFICE USE ONLY

23%	EXECUTIVE, ADMINISTRATIVE AND MANAGERIAL
22	PROFESSIONAL SPECIALTY
6	TECHNICAL AND RELATED SUPPORT
12	SALES
16	ADMINISTRATIVE SUPPORT, INCLUDING CLERICAL
0	PRIVATE HOUSEHOLD
*	PROTECTIVE SERVICE
5	SERVICE, EXCEPT PROTECTIVE AND HOUSEHOLD
2	FARMING, FORESTRY AND FISHING
5	PRECISION PRODUCTION, CRAFT AND REPAIR
4	MACHINE OPERATORS, ASSEMBLERS AND INSPECTORS
1	TRANSPORTATION AND MATERIAL MOVING
3	HANDLERS, EQUIPMENT CLEANERS, HELPERS AND LABORERS
1	MILITARY WORKERS
1	OTHER (Specify):________________________
2	DON'T KNOW/NO RESPONSE

NOTE: DOES NOT ADD UP TO 100% DUE TO MULTIPLE RESPONSES

34. What is the last grade of school that you completed? (READ LIST UNTIL RESPONDENT SELECTS AN ANSWER.)

0	Some elementary school
*	Completed elementary school
4%	Some high school
21	Completed high school
5	Business or technical school
22	Some college
28	Completed college
20	Post-graduate work
*	DON'T KNOW
*	REFUSED

35. Altogether, including yourself, how many people regularly live in your household? (DO NOT READ LIST.)

16%	ONE
32	TWO
21	THREE
20	FOUR
7	FIVE
2	SIX
1	SEVEN
*	EIGHT
*	NINE
0	TEN OR MORE
1	REFUSED

36. INTERVIEWER: RECORD SEX:

45%	MALE
55	FEMALE

Thank you very much for your time and opinions!

INVESTOR ATTITUDES IN THE SPRING OF 1988

EXECUTIVE SUMMARY

A Report Prepared For:

THE NATIONAL ASSOCIATION
OF SECURITIES DEALERS

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We're researching people.

July 1988

Opinion Research Corporation
Post Office Box 183
Princeton, NJ 08542-0183
609-924-5900

An Arthur D. Little Company

INVESTOR ATTITUDES
IN THE SPRING OF 1988

EXECUTIVE SUMMARY

A Report Prepared For

THE NATIONAL ASSOCIATION OF SECURITIES DEALERS

By

OPINION RESEARCH CORPORATION
P.O. Box 183
Princeton, New Jersey

July, 1988

ORC Study #64144

TABLE OF CONTENTS

	Page
Overview	1
Financial Expectations	2
Investment Intentions	3
Investment Goals and Strategy	4
Impact of Possible Events or Actions on Intentions to Invest	4
General Attitudes Toward the Financial Markets	5
Changes in Investment Behavior	6
Impact of Changes in IRA Deductibility	7
Reactions to Proposed Market Reforms	8
Attitudes Toward Stockbrokers	8
Interest in Specific Investment Vehicles	9
About The Survey	10

OVERVIEW

In the spring of 1988, the mood of the average individual investor can be described as cautious, perhaps even nervous, but not as pessimistic. The vast majority of investors are very confident about their own financial prospects, and more guardedly optimistic about the stock markets' prospects. Half of shareholders have made stock investments since the October 1987 stock market crisis, and one-third consider themselves very likely to make new investments in the next year. Most shareholders believe the markets performed efficiently during the market break, are satisfied with the performance of their brokers, and offer only lukewarm support for proposals to reform the financial markets.

Despite these signs of investor confidence, the effects of the market break remain clearly visible. The small investor sees the post-break financial environment as being riskier and more difficult to comprehend than previously existing market conditions. The perception that the markets carry higher levels of risk has had a strong impact on investors' financial planning. In light of this, a large proportion of shareholders have adopted more conservative investment strategies. This new conservatism has led some individual shareholders to avoid equity investments, and many to shun such potentially risky vehicles as stock options, index futures, initial public offerings, or smaller, growth-oriented companies.

This heightened aversion to risk has created a difficult short-term outlook for many types of capital formation. No single change in the financial markets or the overall economic environment appears likely to dispel the public's investment apprehensions.

EXECUTIVE SUMMARY

Financial Expectations

Individual investors are overwhelmingly optimistic about their personal financial prospects, but are somewhat hesitant about the likelihood of major short-term gains in the stock markets.

> Investors are almost ten times as likely to expect to be better off financially in twelve months' time as they are to forecast a deterioration in their own financial position. Altogether, three investors in four (76%) expect to be better off in a year's time than they are now, while only about one in twelve (8%) expects an erosion in their financial position.

On the whole, shareholders are also optimistic, but somewhat more cautious, about the prospects for stock prices over the next year.

> Three investors in five (58%) expect some improvement in the markets. Only one-quarter of the investing public (23%) forecasts a decline in stock prices over the same period. Investors' market forecasts are rather "middle of the road," in that only 3% expect a strong increase, and only 4% project a severe decline.

For some shareholders, personal financial optimism and optimism about the stock markets' prospects appear to go hand in hand.

> Investors who forecast a decline in the markets are less likely to expect their own financial position to improve. However, for the bulk of the investing public there is only a weak connection between their own finances and the likely future performance of the markets. Most seem to expect to grow more prosperous with little help from increasing stock prices.

Investment Intentions

Half (51%) of individual investors have purchased stocks or mutual funds that invest in stocks since the October market break.

> People who have invested during this period offer a variety of different reasons for their decision to invest. Some cite personal financial goals, such as financing retirement, a child's college education or increasing savings as their motivations for investing. Others point to the low stock prices that were available after the market break. Some shareholders invest because they expect the market, or at least their investments, to increase in value.

In making their investments, many investors take a strategic view; that is, a large proportion claim to make investment decisions on a long-term basis, and to be unaffected by the market's near-term prospects.

One-third (33%) of investors believe it is very likely that they will purchase additional stocks or stock mutual funds over the next year.

> An additional 22% of the investing public feel somewhat likely to make new equity investments over the same period. Looking at the other side, 27% describe themselves as very unlikely to invest, while 17% say they are somewhat unlikely to do so.
>
> These proportions are essentially unchanged from research reported in early November, 1987. The events of the eight months between the two studies have apparently had little impact upon the willingness of investors to commit new funds to the financial markets.

Shareholders who have made investments since October are much more likely to expect to make additional investments over the next year than are shareholders who have shied away from committing new funds to the markets in recent months.

> Both investors who have made new investments since October and those who expect to invest in the next twelve months are drawn disproportionately from the most affluent shareholders; those earning more than $50,000 annually and with total investment portfolios of $50,000 and over.

Investment Goals and Strategy

The vast majority (64%) of shareholders say they have invested for long-term appreciation in the value of their holdings.

> Much smaller proportions of the investing public mention income (18%), or short-term appreciation in value (13%) as their main investment objectives. And, significantly, only about one shareholder in ten (9%) claims to be waiting to sell into a market recovery in order to recoup investment losses.

The markets have retained the confidence of the long-term oriented investor.

> Shareholders who are primarily seeking long-term appreciation are more likely than shareholders overall to have invested since October, and to be very likely to make new investments in the upcoming year. On the other hand, the income-oriented individual investor has to some extent turned away from stock investments. Shareholders seeking primarily dividends tend not to have made post-October investments, or plans for new stock purchases in the next year, to the same extent as other investors.

A majority (56%) of investors claim that their investment strategies have not changed since the October market break.

> However, a substantial minority (39%) claim to have shifted to more conservative investment approaches. Shareholders who say they are likely to invest in the next twelve months are less likely than other investors to have adopted more conservative strategies. Not surprisingly, however, investors who expect a decline in share prices are more likely to have shifted to more conservative approaches.

Impact of Possible Events or Actions on Intentions to Invest

No single change in the stock markets or underlying economic conditions appears likely to change most shareholders' investment intentions.

> This finding is not surprising given the long-term orientation of most individual investors. None of a number of possible events or actions studied, such as reductions in the trade or budget deficits, appreciation or depreciation of the value of the dollar, a major increase or decline in stock prices, elimination of program trading, or moderation in market volatility would cause even one shareholder in five to become much more likely to invest over the course of the next twelve months. And among those who already considered themselves unlikely to invest in the coming year, the impact of these possible events is even more muted and indecisive.

> Interestingly, investors claim they would be somewhat more likely to buy if the market is declining, than if it increases significantly in value. The experience of buying into the bull market of 1987 may have caused many shareholders to shy away from investing in stocks that are rising rapidly in price.

General Attitudes Toward the Financial Markets

Most individual investors appear to remain confident in the efficiency and competence of the stock markets.

> Two-thirds (66%) of all shareholders believe that the markets performed well during the October crisis. Despite this overall vote of confidence from the investing public, the markets have no grounds for complacency. Perceptions of flaws in the markets' performance have had some negative impact upon the investing outlook and behavior of significant minorities of the investing public.
>
> For example, investors who perceive the markets as having increased in riskiness, who have adopted more conservative strategies, or who expect a decline in share prices, tend to be less likely to look favorably on the stock markets' October performance.

Although most investors seem to remain confident in the performance of the financial markets, they also perceive the markets to have undergone substantial change.

> The markets are seen by many investors as being increasingly unfamiliar and challenging places. Strong majorities of the investing public perceive the financial markets as having become increasingly risky for the individual investor (61%) and dominated by institutional investors (70%). At the same time they see the markets as becoming increasingly globalized (63%) and believe that trading in options and futures contracts have made it more difficult for the individual shareholder to make informed decisions (81%).

Changes in Investment Behavior

The October market break seems to have created significant changes in future investment behavior by sizable proportions of individual shareholders.

> Many investors have reacted to the volatility of the markets by shifting funds out of what they perceive as being especially risky investment vehicles, or by changing their anticipated investing behavior. Half or more of the investing public describe themselves as less likely to invest in initial public offerings, foreign stocks, the stocks of smaller growth-oriented companies or to buy stocks on margin than they were before the market break.
>
> A substantial minority (40%) of investors say they are less likely to invest in any common stocks following the October break in prices. Roughly the same proportion (35%) believe themselves to be less likely to invest in mutual funds. Only about half as many investors report being more likely to invest in common stocks (15%) or mutual funds (22%). (Nonetheless, as already seen, those investors who think it is likely that they will make stock investments over the next 12 months outnumber those who consider themselves unlikely to invest by a 55%-44% margin.)

Although many of the changes in individual shareholder behavior present rather grim news for capital formation, and suggest that all equity investments (and particularly those that entail a relatively high degree of risk) will have a more difficult time in attracting funds, there is another, brighter side to the picture.

> Half (52%) of investors report making attempts to increase their personal savings, compared to only 13% who consider themselves less likely to try to save more than they were saving before October.
>
> In a related area, a plurality of shareholders (36%) claim to be more likely to delay making major purchases than was the case before October. The securities industry thus has a potentially greater pool of investor capital to draw upon, although it may face resistance to mobilizing this capital for investments in stocks, or other vehicles that are perceived as risky.

The individual investor's perception of risk is a key factor in determining changes in his or her investment strategy and behavior.

> Investors who believe that there is much greater risk in the post-October market environment consistently think and plan to act differently from those who do not see themselves as being confronted by greater uncertainty in the financial markets.
>
> As might be expected, shareholders who perceive greater risks in the markets are much more likely to have adopted more conservative financial strategies than are those who believe the riskiness of investing is essentially unchanged from pre-October conditions. These two groups, those who perceive heightened risk and those shifting to more conservative investing postures, overlap substantially and tend to hold the same outlook regarding investments.
>
> The most dramatic and perhaps most important impact that perceptions of heightened risk have on investors relates to their plans to invest in common stock. Investors who believe the markets to be more risky and those who have become more conservative in their investment strategy are almost twice as likely to avoid new common stock investments as shareholders whose risk perceptions and investment strategies have not changed.
>
> It is worth noting that mutual funds are not seen as a safe haven by either risk-conscious or conservative shareholders. Both groups are less likely than are investors overall to plan new investments through mutual funds. Conservative investors are, however, somewhat more likely than are shareholders with unchanged strategies to invest in large, well-known companies.

Impact of Changes in IRA Deductibility

The 1987 tax reform bill's elimination of full deductibility for IRAs may have exacerbated some of the financial markets' difficulties in mobilizing new capital.

> A majority (57%) of investors currently have an IRA, and about half (51%) of those with IRAs report a change in its deductibility. Almost half (48%) of investors with IRAs that changed in deductibility claim to have reduced their savings as a result of the change. And three-tenths (30%) of investors who have suffered a change in IRA deductibility believe the change has caused them to invest less in common stocks. The impact of this change in investment behavior is more pronounced among the already skittish, risk-conscious shareholders, than it is among investors who perceive no increase in the markets' riskiness.

Reactions to Proposed Market Reforms

Individual investors offer only lukewarm support for many proposed reforms in the financial markets.

> Only slim majorities or pluralities of shareholders (between 42% and 53%) favor five possible market reforms; greater control over program trading; suspension of stock trading in the event of rapid price changes; increase in margin requirements for option trading; increase in margin requirements for stock trading; or creation of a new federal regulatory agency.
>
> Although support for these proposed reforms is somewhat limited, there is also little opposition to most of them. The only potential reform that provokes strong opposition is the creation of a new regulatory body overseeing the financial markets, which is opposed by 34% of the investing public.

Attitudes Toward Stockbrokers

In the wake of the break in prices, individual investors hold ambivalent attitudes toward stockbrokers.

> On the one hand, roughly three investors in five (61%) believe that is more difficult currently to have confidence in the advice given by a stockbroker. Essentially the same proportion (60%) of those investors who currently have security trading accounts also report increasing doubts about stockbrokers' advice. On the other hand, only 30% of investors say they are now less likely to seek a broker's advice before making investments. In fact, a somewhat larger proportion (35%) feel they are more likely to seek the advice of a broker. Newly conservative and risk-conscious investors, and those who depend upon brokers and financial advisors for guidance, appear to be particularly likely to seek the advice of a broker before investing.

Most shareholders with securities trading accounts are satisfied, though not elated, with the performance of their brokers.

> Altogether, about four investors in five (78%) (among those who have brokerage accounts) are satisfied with their broker's performance, although only one in three (33%) are very satisfied. Virtually none (1%) of the investors with trading accounts report any unresolved complaints to their brokers, and only a minuscule proportion (3%) report having experienced delays in redeeming mutual funds.

Interest in Specific Investment Vehicles

Individual investors have limited experience with and limited interest in investing in initial public stock offerings, private stock offerings, and foreign stocks.

> One-quarter (27%) of shareholders claim to have invested in an IPO, and the same proportion (27%) of those who have not invested in them say they would be interested in investing in IPOs if there were a convenient way to do so.
>
> Only one shareholder in five (21%) has invested in stocks of foreign companies, and a relatively small proportion (17%) would be interested in making such an investment if it were conveniently available to them.
>
> One-fifth (19%) of the shareholding public has invested in a private offering stock. Of those who have never made this type of investment, 29% say they would be interested in buying into a private offering if it were conveniently available.
>
> Shareholders with incomes over $50,000 are particularly likely to have invested in all three of these investment vehicles.

About The Survey

A national probability sample, projectable to total U.S. telephone households, was used to randomly select the households contacted for this survey. Once contact was made, a screening procedure was used to determine whether anyone in the household owned stocks (or mutual funds that invest in stocks) at any point during the preceding year, and whether the respondent is involved in the household's financial decision making. If the response to each of these questions was affirmative, the interview was conducted. A total of 1,008 households were interviewed.

Interviewing was conducted between May 9 and June 10, 1988.

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James E. Buck
Senior Vice President
and Secretary

NYSE
New York
Stock Exchange, Inc.

October 31, 1988

Ms. Sharon Lawson
Branch Chief
Division of Market Regulation
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, DC 20549

Re: File No. SR-NYSE-88-34

Dear Ms. Lawson:

Pursuant to Rule 19b-4 under the Securities Exchange Act of 1934, we enclose for filing 12 copies of Form 19b-4, at least one of which has been manually signed. The filing contains two agreements regarding trading restrictions between New York Stock Exchange and Chicago Mercantile Exchange, and the New York Stock Exchange and New York Futures Exchange, which we are proposing to file as a "stated policy, practice or interpretation" with respect to existing Rule 476.

Sincerely yours,

J E Buck

SR-NYSE-88-34

SECURITIES AND EXCHANGE COMMISSION

Washington, D. C. 20549

Form 19b-4

Proposed Rule Change

by

NEW YORK STOCK EXCHANGE

Pursuant to Rule 19b-4 under the
Securities Exchange Act of 1934

Proposed Rule Change - New York Stock Exchange/Chicago Mercantile Exchange and New York Stock Exchange/New York Futures Exchange Intermarket Trading Restrictions

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CONTENTS PAGE

1. Text of the Proposed Rule Change 1
2. Procedures of the Self-Regulatory Organization 1
3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change 1
4. Self-Regulatory Organization's Statement on Burden on Competition 3
5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others 4
6. Extension of Time Period for Commission Action 4
7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2) 4
8. Proposed Rule Change Based on Rules of Another Self-Regulatory Organization or of the Commission 5
9. Exhibits 5

Exhibit 1 - Form of Notice of Proposed Rule Change for Federal Register

Exhibit 2 - NYSE Information Memorandum (April 13, 1988) Seeking Comment on Adoption of a Possible Prohibition Against Index Futures Frontrunning

Written Comments Received:

Merrill Lynch, Pierce, Fenner & Smith Inc.
Morgan Stanley & Co.
Securities Industry Association

Exhibit A - Proposed Information Memorandum on New York Stock Exchange/Chicago Mercantile Exchange Intermarket Trading Restrictions

Proposed Information Memorandum on New York Stock Exchange/New York Futures Exchange Intermarket Trading Restrictions

1. Text of Proposed Rule Change

(a) The proposed rule change consists of two agreements in regard to certain intermarket trading restrictions between the New York Stock Exchange and the Chicago Mercantile Exchange and the New York Stock Exchange and the New York Futures Exchange. The proposed rule change is set forth in Exhibit A, which consists of two proposed Information Memoranda. These Memoranda are being submitted as a "stated policy, practice or interpretation" with respect to the meaning and enforcement of existing Exchange Rule 476.

(b) The proposed rule change will not have any direct effect, or any significant indirect effect, on any other Exchange rules.

(c) Not applicable.

2. Procedures of the Self-Regulatory Organization

New York Stock Exchange management has approved the policy agreed upon by the New York Stock Exchange and the Chicago Mercantile Exchange and the New York Stock Exchange and the New York Futures Exchange, as set forth in Exhibit A, pursuant to delegated authority. No further action is required and therefore the Exchange's internal procedures with respect to the proposed rule change have been completed.

The names and telephone numbers of the persons on the Exchange staff prepared to respond to questions and comments on the proposed rule change are:

Agnes M. Gautier
Vice President
Market Surveillance
(212) 656-4608

Jack Symington
Director
Market Surveillance
(212) 656-6534

3. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

Purpose

On April 13, 1988 the Exchange issued an Information Memorandum to its membership stating that it was considering the adoption of an interpretation whereby trading in index futures immediately prior to and with knowledge of the execution of one or more "baskets" of stock that favorably impact the value of the underlying index might constitute frontrunning, and thus might constitute a violation of just and equitable principles of trade under Exchange Rule 476. (See Exhibit 2.) In this Information Memorandum the Exchange invited comments from its members and member organizations concerning the proposed interpretation. The comments received by the Exchange are discussed in Section 5 infra.

The New York Stock Exchange and the Chicago Mercantile Exchange, and the New York Stock Exchange and the New York Futures Exchange ("NYFE") have recently determined to adopt a policy, uniform as between the respective markets, (see Exhibit A), which specifically defines and prohibits certain intermarket trading between their respective equities and futures markets, while not prohibiting legitimate trading activities.*

The policy prohibits a member or person associated with a member or member organization from executing or causing the execution of, for an account in which such member or person has a direct or indirect pecuniary interest, or for an account with respect to which such member or person exercises investment discretion, certain transactions, as described below, to take advantage of material, non-public information which can reasonably be expected to have an immediate, favorable impact in relation to such transactions. Any member or persons executing or causing the execution of such transactions may be in violation of just and equitable principles of trade under Rule 476.

Specifically the policy provides that a transaction in any stock index futures contract, or option on a stock index future when such member or person has acquired knowledge of the imminent execution of another person's stock program transaction may be in violation of just and equitable principles of trade, where, as noted above, a member or person associated with a member is trading to take advantage of material, non-public information which can reasonably be expected to have an immediate, favorable impact in relation to such transaction. Moreover, the Exchange, and the CME, and the NYFE, have also recognized that transactions in stock index futures or options on stock index futures may have some effect on the market in the underlying equities themselves. Therefore, the memorandum states that conversely, certain transactions in the reverse order could also constitute a violation of just and equitable principles of trade. In this instance, stock program transactions, when such member or person has acquired knowledge of the imminent execution of another person's order(s) in stock index futures contracts or options on stock index futures, may also be in violation of just and equitable principles of trade.

---

* The policy filed herein pertains to intermarket trading between the NYSE equities market and, respectively, the Chicago Mercantile Exchange's and the New York Futures Exchange's futures market. The Exchange's policies with regard to frontrunning in the context of trading in standardized options on individual stocks, and frontrunning in the context of trading in index options and options on over-the-counter stocks, were filed in SR-NYSE-87-36.

The exchanges have agreed that it is not necessary to demonstrate that another person has been disadvantaged when determination is being made as to whether a member or person has taken advantage of material, non-public information. Furthermore, such member or person may be deemed to be in violation of just and equitable principles of trade regardless of whether such other person has given permission for such trading.

However, this policy is not intended to prevent such member or person from establishing in a futures market, a bona fide hedge of risk such member or person may have assumed or agreed to assume in facilitating the execution of any other person's stock program orders. The risk to be hedged must be the result of having established a position or having given a firm commitment to assume a position, and the offsetting hedging transaction must be commensurate with such risk.

Additionally, this policy is not intended to prevent a member or person from implementing a legitimate proprietary market strategy involving a stock program and a related stock index futures transaction by executing the stock index futures trade(s) prior to the execution of the stock program. However, the execution of a transaction in one market to take advantage of such member's or person's imminent transaction in a related market, may be considered to be a manipulative activity.

The agreement between the New York Stock Exchange and the New York Futures Exchange is identical to that between the New York Stock Exchange and the Chicago Mercantile Exchange, with one additional restriction. This agreement further states that a transaction in any stock index option, when such member or person has acquired knowlege of the imminent execution of another person's order(s) in stock index futures contracts or options on a stock index future may also be in violation of just and equitable principles of trade.

Therefore, this agreement states that this policy is not intended to prevent such member or person from establishing, in a futures market, a bona fide hedge of risk such member or person may have assumed or agreed to assume in facilitating the execution of any other person's stock index option orders as well as another person's stock program orders.

Similarly, this agreement states that a member or person associated with a member organization who implements a proprietary market strategy involving stock index option transaction(s) as well as a stock program and a related stock index futures transaction by executing the stock index futures trade(s) prior to the execution of the stock index option transaction(s) as well as the stock program will not be deemed to be in violation of this policy.

Statutory Basis

The Exchange believes the proposed rule change will promote the purposes of Section 6(b)(5) of the Securities Exchange Act of 1934 in that it can be said to "promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating ... transactions in securities, ... and, in general, to protect investors and the public interest."

4. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

5. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

In its April 13, 1988 Information Memorandum notifying its membership of the possible application of the frontrunning policy to index futures trading, the Exchange sought comments from its members. Comment letters were received from Merrill Lynch, Pierce, Fenner and Smith Inc., Morgan Stanley & Co. and the Securities Industry Association. These comment letters are annexed as part of Exhibit 2.

The Exchange believes that the concerns raised in these comment letters have been substantially addressed by the more specific definition of frontrunning as applied to trading in baskets of stocks and futures or options on futures agreed to by the New York Stock Exchange and the CME, and the New York Stock Exchange and the New York Futures Exchange and set forth in the Information Memoranda being filed herein. The most significant concerns were that legitimate trading activities, such as the facilitation of customer orders and the hedging of proprietary positions, which are, of course, beneficial to the market, should not be inhibited by this rule.

The Information Memoranda address these concerns by stating that the Exchange does not intend to prohibit a bona fide hedge assumed in facilitating the execution of any other person's stock program orders. Additionally, the Exchange does not seek to inhibit proprietary trading, including the execution of stock index futures prior to a stock program, unless the transaction is intended to take advantage of that member or person's imminent stock program transaction. The Exchange's more specific definition of intermarket frontrunning as a transaction based upon the knowledge of another person's activity, and not a member or member organization's own activity, whether in stocks or stock index futures contracts or options, prohibits clearly abusive trading, while not prohibiting member firms from engaging in legitimate hedging of their own positions.

6. Extension of Time Period for Commission Action

Not applicable.

7. Basis for Summary Effectiveness Pursuant to Section 19(b)(3) or for Accelerated Effectiveness Pursuant to Section 19(b)(2)

Not applicable.

8. Proposed Rule Change Based on Rules on Another Self-Regulatory Organization or of the Commission

This interpretation is not based on the rules of another self-regulatory organization regulated by the Commission, but was developed jointly with the Chicago Mercantile Exchange and the New York Futures Exchange, whose interpretations are subject to oversight by the Commodities Futures Trading Commission.

9. **Exhibits**

Exhibit 1 - Form of Notice of Proposed Rule Change for *Federal Register*

Exhibit 2 - NYSE Information Memorandum (April 13, 1988) Seeking Comment on the Anticipated Prohibition Against Index Futures Frontrunning

Written Comments Received:

Merrill Lynch, Pierce, Fenner & Smith Inc.
Morgan Stanley & Co.
Securities Industry Association

Exhibit A - Proposed Information Memorandum on New York Stock Exchange/Chicago Mercantile Exchange Intermarket Trading Restrictions

Proposed Information Memorandum on New York Stock Exchange/New York Futures Exchange Intermarket Trading Restrictions

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the self-regulatory organization has duly caused this filing to be signed on its behalf of the undersigned thereunto duly authorized.

NEW YORK STOCK EXCHANGE, INC.

By: J E Buck
James E. Buck
Secretary

Exhibit I

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34- ; File No. SR-NYSE-88-34)

Self-Regulatory Organization; Proposed Rule Change by New York Stock Exchange, Inc. relating to certain intermarket trading restrictions adopted by New York Stock Exchange and Chicago Mercantile Exchange, and the New York Stock Exchange and the New York Futures Exchange.

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934, 15 U.S.C. 78s(b)(1), notice is hereby given that on October 31, 1988, 1988, the New York Stock Exchange, Inc. filed with the Securities and Exchange Commission the proposed rule change as described in Items I, II and II below, which items have been prepared by the self-regulatory organization. The Commission is publishing this notice to solicit comments on the proposed rule change from interested parties.

I. Self-Regulatory Organization's Statement of the Terms of Substance of the Proposed Rule Change

The proposed rule change consists of two agreements in regard to certain intermarket trading restrictions between the New York Stock Exchange and the Chicago Mercantile Exchange and the New York Stock Exchange and the New York Futures Exchange.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the self-regulatory organization included statements concerning the purpose of and basis for the proposed rule change. The text of these statements may be examined at the places specified in Item IV below and is set forth in Sections (A), (B), and (C) below.

(A) Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Change

(1) Purpose

On April 13, 1988 the Exchange issued an Information Memorandum to its membership stating that it was considering the adoption of an interpretation whereby trading in index futures immediately prior to and with knowledge of the execution of one or more "baskets" of stock that favorably impact the value of the underlying index might constitute frontrunning, and thus might constitute a violation of just and equitable principles of trade under Exchange Rule 476. (See Exhibit 2.) In this Information Memorandum the Exchange invited comments from its members and member organizations concerning the proposed interpretation. The comments received by the Exchange are discussed in Section 5 *infra*.

The New York Stock Exchange and the Chicago Mercantile Exchange ("CME"), and the New York stock Exchange and the New York Futures Exchange ("NYFE") have recently determined to adopt a policy, uniform as between the respective markets, (see Exhibit A), which specifically defines and prohibits certain intermarket trading between their respective equities and futures markets, while not prohibiting legitimate trading activities.*

The policy prohibits a member or person associated with a member or member organization from executing or causing the execution of, for an account in which such member or person has a direct or indirect pecuniary interest, or for an account with respect to which such member or person exercises investment discretion, certain transactions, as described below, to take advantage of material, non-public information which can reasonably be expected to have an immediate, favorable impact in relation to such transactions. Any member or persons executing or causing the execution of such transactions may be in violation of just and equitable principles of trade under Rule 476.

Specifically the policy provides that a transaction in any stock index futures contract, or option on a stock index future when such member or person has acquired knowledge of the imminent execution of another person's stock program transaction may be in violation of just and equitable principles of trade, where, as noted above, a member or person associated with a member is trading to take advantage of material, non-public information which can reasonably be expected to have an immediate, favorable impact in relation to such transaction. Moreover, the Exchange, the CME and the NYFE, have also recognized that transactions in stock index futures or options on stock index futures may have some effect on the market in the underlying equities themselves. Therefore, the memorandum states that conversely, certain transactions in the reverse order could also constitute a violation of just and equitable principles of trade. In this instance, stock program transactions, when such member or person has acquired knowledge of the imminent execution of another person's order(s) in stock index futures contracts or options on stock index futures, may also be in violation of just and equitable principles of trade.

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* The policy filed herein pertains to intermarket trading between the NYSE equities market and, respectively, the Chicago Mercantile Exchange's and the New York Futures Exchange's futures market. The Exchange's policies with regard to frontrunning in the context of trading in standardized options on individual stocks, and frontrunning in the context of trading in index options and options on over-the-counter stocks, were filed in SR-NYSE-87-36.

The exchanges have agreed that it is not necessary to demonstrate that another person has been disadvantaged when determination is being made as to whether a member or person has taken advantage of material, non-public information. Furthermore, such member or person may be deemed to be in violation of just and equitable principles of trade regardless of whether such other person has given permission for such trading.

However, this policy is not intended to prevent such member or person from establishing in a futures market, a bona fide hedge of risk such member or person may have assumed or agreed to assume in facilitating the execution of any other person's stock program orders. The risk to be hedged must be the result of having established a position or having given a firm commitment to assume a position, and the offsetting hedging transaction must be commensurate with such risk.

Additionally, this policy is not intended to prevent a member or person from implementing a legitimate proprietary market strategy involving a stock program and a related stock index futures transaction by executing the stock index futures trade(s) prior to the execution of the stock program. However, the execution of a transaction in one market to take advantage of such member's or person's imminent transaction in a related market, may be considered to be a manipulative activity.

The agreement between the New York Stock Exchange and the New York Futures Exchange is identical to that between the New York Stock Exchange and the Chicago Mercantile Exchange, with one additional restriction. This agreement further states that a transaction in any stock index option, when such member or person has acquired knowlege of the imminent execution of another person's order(s) in stock index futures contracts or options on a stock index future may also be in violation of just and equitable principles of trade.

Therefore, this agreement states that this policy is not intended to prevent such member or person from establishing, in a futures market, a bona fide hedge of risk such member or person may have assumed or agreed to assume in facilitating the execution of any other person's stock index option orders as well as another person's stock program orders.

Similarly, this agreement states that a member or person associated with a member organization who implements a proprietary market strategy involving stock index option transaction(s) as well as a stock program and a related stock index futures transaction by executing the stock index futures trade(s) prior to the execution of the stock index option transaction(s) as well as the stock program will not be deemed to be in violation of this policy.

(2) Statutory Basis for the Proposed Rule Change

The Exchange believes the proposed rule change will promote the purposes of Section 6(b)(5) of the Securities Exchange Act of 1934 in that it can be said to "promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating ... transactions in securities, ... and, in general, to protect investors and the public interest."

(B) Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

(C) Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants, or Others

In its April 13, 1988 Information Memorandum notifying its membership of the possible application of the frontrunning policy to index futures trading, the Exchange sought comments from its members. Comment letters were received from Merrill Lynch, Pierce, Fenner and Smith Inc., Morgan Stanley & Co. and the Securities Industry Association. These comment letters are annexed as part of Exhibit 2.

The Exchange believes that the concerns raised in these comment letters have been substantially addressed by the more specific definition of frontrunning as applied to trading in baskets of stocks and futures or options on futures agreed to by the New York Stock Exchange and the CME, and the New York Stock Exchange and the NYFE, and set forth in the Information Memoranda being filed herein. The most significant concerns were that legitimate trading activities, such as the facilitation of customer orders and the hedging of proprietary positions, which are, of course, beneficial to the market, should not be inhibited by this rule.

The Information Memoranda address these concerns by stating that the Exchange does not intend to prohibit a bona fide hedge assumed in facilitating the execution of any other person's stock program orders. Additionally, the Exchange does not seek to inhibit proprietary trading, including the execution of stock index futures prior to a stock program, unless the transaction is intended to take advantage of that member or person's imminent stock program transaction. The Exchange's more specific definition of intermarket frontrunning as a transaction based upon the knowledge of another person's activity, and not a member or member organization's own activity, whether in stocks or stock index futures contracts or options, prohibits clearly abusive trading, while not prohibiting member firms from engaging in legitimate hedging of their own positions.

III. Date of Effectiveness of the Proposed Rule Change and Timing for Commission Action

Within 35 days of the date of publication of this notice in the Federal Register or within such longer period (i) as the Commission may designate up to 90 days of such date if it finds such longer period to be appropriate and publishes its reasons for so finding or (ii) as to which the self-regulatory organization consents, the Commission will:

(A) By order approve such proposed rule change or

(B) Institute proceedings to determine whether the proposed rule change should be disapproved.

IV. Solicitation of Comments

Interested persons are invited to submit data, views and arguments concerning the foregoing. Persons making written submissions should file six copies thereof with the Secretary, Securities and Exchange Commission, 450 Fifth Street, N. W., Washington, D.C. 20569.

Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 522, will be available for inspection and copying in the Commission's Public Reference Section, 450 Fifth Street, N. W., Washington, D.C. Copies of such filing will also be available for inspection and copying at the principal office of the above-mentioned self-regulatory organization. All submissions should refer to the file number in the caption above and should be submitted by [insert date].

For the Commission by the Division of Market Regulation, pursuant to delegated authority.

Secretary

Information Memo

EXHIBIT 2
Page 1

New York
Stock Exchange, Inc.

April 13, 1988

11 Wall Street
New York, NY 10005

Market Surveillance Services

TO: ALL MEMBERS AND MEMBER-ORGANIZATIONS

SUBJECT: PROHIBITION AGAINST INDEX FUTURES FRONTRUNNING

Program trading activity involving the purchase or sale of "baskets" of stock on the New York Stock Exchange has raised concerns over possible trading abuses related to the execution of such program orders. The Exchange has conducted numerous analyses and reviews involving program trading and its effects on the stock market and has concluded, in part, that the level of such trading which is done in conjunction with activity on the various index futures markets gives rise to the potential for trading abuses involving index futures contracts and the execution of stock programs.

Specifically, the Exchange is considering the adoption of an interpretation whereby trading in index futures immediately prior to and with knowledge of the execution of one or more baskets of stock that favorably impact the value of the underlying index could constitute frontrunning and, thus, be a violation of just and equitable principles of trade (Exchange Rule 476). The rule would be consistent with previous Exchange definitions of frontrunning as contained in Information Memos 80-38 dated September 11, 1980 and 85-36 dated November 6, 1985. When a member or person associated with a member or member organization is in possession of material non-public market information concerning one or more baskets of stock, the execution of which affects the value of an index, trading in futures on that index before information concerning the execution of the stock basket(s) has been made publicly available, to take advantage of the non-public information, may violate just and equitable principles of trade.

All members and member organizations are invited to submit any comments concerning the foregoing proposed interpretation. All such comments are to be submitted by no later than May 6, 1988 and are to be directed, in writing, to Agnes M. Gautier, Vice President, Market Surveillance, 11 Wall Street, 11th Floor, New York, New York 10005.

Donald Solodar

Donald J. Solodar
Senior Vice President

EXHIBIT 2
Page 2

Merrill Lynch Capital Markets
Merrill Lynch World Headquarters
North Tower
World Financial Center
New York, New York 10281-1203
212 449 4385
Telex 229081 MLET
FAX 212 449 4590

Merrill Lynch

John B. Manning, Jr.
Vice President
General Counsel
Office of the General Counsel-Trading

May 12, 1988

Agnes M. Gautier, Esq.
Vice President, Market Surveillance
New York Stock Exchange, Inc.
11 Wall Street
New York, NY 10005

Re: Proposed Interpretation of NYSE Exchange Rule 476 to Prohibit Index Futures Frontrunning

Dear Ms. Gautier:

In a New York Stock Exchange ("NYSE") Information Memorandum dated April 13, 1988 (the "Information Memo") the NYSE indicates that it is considering, and requests comment on, an interpretation of NYSE Rule 476 that would prohibit index futures frontrunning. Merrill Lynch, Pierce, Fenner & Smith Incorporated ("Merrill Lynch") appreciates this opportunity to submit its comments. Merrill Lynch is a broker-dealer registered under Section 15 of the Securities Exchange Act of 1934 and a futures commission merchant registered under Section 4d of the Commodity Exchange Act. Merrill Lynch and its various affiliates transact business on both securities exchanges and futures exchanges on behalf of customers as well as for proprietary purposes.

We agree with the NYSE that certain types of intermarket transactions may be inappropriate and not in the public interest, and we applaud the NYSE in its effort to address this issue expeditiously. We believe, however, that it is important that any prohibition against such activity should specifically identify the violative conduct, and should be carefully crafted in order to eliminate abusive trading behavior without inhibiting legitimate trading. We further believe that intermarket frontrunning is precisely the sort of issue as to which a coordinated regulatory approach, involving cooperation between affected market centers, would be appropriate.

EXHIBIT 2
Page 3

The January 8, 1988 Report of the Presidential Task Force on Market Mechanisms ("Brady Report") clearly indicated that our securities and futures markets have in many senses become a single market and as such require regulation on a coordinated or unified basis. We agree. Merrill Lynch believes that coordinated regulation and enhanced information-sharing between market centers are the cornerstones on which market reform must be based. Consequently, we believe that the implementation of consistent frontrunning interpretations by the various securities and futures markets would be highly desirable. This issue provides an important opportunity to establish the ability and the willingness of regulators, market centers and our industry to work together to develop a comprehensive, consistent regulatory scheme.

We understand that the Chicago Mercantile Exchange is also considering the publication of a frontrunning interpretation. Approaching these interpretations in a coordinated manner would be worthwhile for all the reasons set forth above. Moreover, to the extent that regulatory coordination in this area would eliminate differences in the rules or interpretations of different regulatory or self-regulatory organizations where no different result is intended (and, consequently, would also preclude the development of slightly different behavior in different markets based on unintended semantic distinctions), it is imperative. It is precisely this sort of regulatory subject matter that the Brady Report recommends be coordinated, so that brokers and their customers who engage in transactions in these differently regulated, but unified, markets become subject to the same or consistent rules.

While the Information Memo does not set forth the precise language of the interpretation that the NYSE is considering, we are also concerned, from a reading of the descriptive text of the Information Memo, that the proposed interpretation may prohibit certain legitimate trading strategies. For instance, a broker-dealer having implemented a proprietary market strategy involving a block or basket of stocks and a related futures transaction might be prohibited from executing (or completing) that transaction upon becoming aware of a customer order on the same side of the market, notwithstanding that the customer order was not the impetus for the strategies being implemented. Similarly, no broker-dealer should be prohibited from trading to hedge its own inventory because it is holding a customer order (still subject, of course, to rules that require a broker to execute customer orders before executing proprietary orders). The liquidity that is provided by a block trading desk depends on the traders' willingness to commit firm capital to facilitate customer orders. And that, in turn, depends on the firm's being able to hedge the risk associated with the resulting positions. The NYSE's proposed interpretation should make it clear that it prohibits trading that is based

EXHIBIT 2
Page 4

solely on knowledge of a customer order, but does not prohibit proprietary trading having an independent economic basis and purpose simply because of the coincidence of a customer's having placed (or being about to place) an order, even where the broker has knowledge of the order.

It is also important to recognize that a customer order may be placed subject to certain contingencies that may not occur for hours, if at all, and to carefully define the impact of the proposed prohibition in such circumstances. For example, a customer may place an order to sell stocks and buy futures in the event that futures prices reach certain discounts in relation to the value of the stocks in an index. To effect a proprietary transaction with knowledge of that order at a time when the stipulated market condition is not present simply does not involve frontrunning. In our view, the interpretation should be drafted to make it clear that frontrunning involves trading on the basis of a customer order that is imminent, the terms of which are reasonably certain, and which can reasonably be expected to have a favorable impact on the profitability of the broker-dealer's frontrunning transaction.

We note that the proposed interpretation prohibits frontrunning only when the frontrunning transaction takes place in the futures market. There seems to be no reason that the interpretation should not similarly preclude proprietary trading in the equity markets on the basis of a customer order about to be executed in the futures market the terms of which are reasonably certain, and which can reasonably be expected to affect favorably the profitability of the equity transaction. We understand that existing NYSE prohibitions against frontrunning in the securities options markets do not envision frontrunning in the underlying securities; nor, as an economic matter, should they. In the markets for index futures and the related securities, however, an economic purpose may exist for a frontrunning transaction to be effected in the cash securities market. Frontrunning, appropriately defined, is improper whether conducted in the futures or the securities markets.

Finally, we believe that it is imperative that the interpretation provide as much clarity and certainty as possible. Although the Information Memo states that the proposed interpretation would be consistent with previous frontrunning definitions, as set forth in Information Memoranda 80-38 and 85-36, in some respects the proposed prohibition is broader. Certainly, it is being applied to situations altogether different from the options frontrunning of a block order in a particular stock that prompted the existing interpretations in the first instance. Consequently, it would be helpful to provide examples of abusive (and permitted) practices in order to address properly the futures and securities market issues that are not present in existing options frontrunning prohibitions.

EXHIBIT 2
Page 5

We are hopeful our comments will assist you in your consideration of this issue. If you would like to discuss these matters, or if we can provide you with additional assistance before an interpretation is published, we would be pleased to do so. I can be reached at 449-4385.

Very truly yours,

John B. Manning, Jr.

EXHIBIT 2
Page 6

MORGAN STANLEY

MORGAN STANLEY & CO
INCORPORATED
1251 AVENUE OF THE AMERICAS
NEW YORK, NEW YORK 10020

May 19, 1988

Agnes M. Gautier
Vice President
Market Surveillance
New York Stock Exchange
11 Wall Street
New York, New York 10005

RE: NYSE Information Memo 88-9 Regarding Index Futures Frontrunning

Dear Ms. Gautier:

This is submitted in response to the NYSE's Information Memo 88-9 inviting comments from members concerning a proposed interpretation of NYSE Rule 476 regarding index futures frontrunning.

We support the principle that the confidentiality of non-public customer information should be maintained and that a misuse of confidential customer information, whether it be in the futures, options or securities markets, should be discouraged. If a rule or interpretation is adopted by the NYSE to prohibit intermarket frontrunning, it must be carefully and clearly constructed to avoid the prohibition of legitimate trading, hedging and arbitrage activities. Moreover, the free flow of market information, essential to the efficiency of securities markets, must not be unduly impeded. We also believe that it is important for all exchanges to work together to provide rules and guidelines which represent a consistent approach in order that the application of frontrunning rules to particular intermarket transactions can be uniformly interpreted by all market participants.

Professional traders play important beneficial roles in the equity markets as providers of liquidity and facilitators of customer transactions. Intermarket trading positions are often established by NYSE member firms for the purpose of facilitating customer transactions or hedging risk associated with such transactions. These facilitation and risk hedging transactions serve to improve the efficient execution of customer transactions, and, moreover, reduce overall execution costs for such customers. Because of the beneficial nature of such

EXHIBIT 2
Page 7

facilitation and risk hedging activities, any rule interpretation prohibiting frontrunning should clearly exclude these activities from the prohibitions of the rule interpretation. Moreover, rules or their interpretations, prohibiting intermarket frontrunning should only concern customer transactions and not attempt to include the complex subject of so called "self-frontrunning".

As we understand the proposed interpretation, a prohibited intermarket transaction as formulated in the NYSE's Information Memo 88-9, would involve primarily four factors:

1. trading by a member or person associated with a member while "in possession of" information;
2. that the possessed information was "material non-public market information concerning one or more baskets of stocks;"
3. that the execution of the baskets affects the value of an index; and
4. that the trading was "to take advantage of the non-public information."

We agree with the NYSE that an interpretation of intermarket frontrunning should focus on trading which is deliberately designed to take advantage of customer information. We believe however, that the rule interpretation as formulated above is vague, overly broad and would serve to inhibit legitimate trading, hedging and arbitrage activities. We believe that a more focused approach would better serve to deter trading abuses related to the execution of program orders.

For example, while we recognize that the "in possession of" standard is consistent with previous NYSE frontrunning interpretations, we believe that this standard would be particularly inappropriate and overbroad in the intermarket trading context. This standard would impose liability on a member firm where the trader responsible for trading decisions executes a transaction while completely unaware of relevant non-public information known by other sales or trading professionals who likewise, were unaware of the trading decisions being made by other traders in the firm. In addition, the prohibition would apply where the trader knew of the non-public information, but was acting pursuant to a totally independent and possibly pre-existing trading strategy. A broad standard, such as this, is unnecessary since the conduct to be deterred is the intentional misuse of information.

EXHIBIT 2
Page 8

An alternative standard, which would address potentially abusive behavior in a more direct fashion, would be to prohibit trading "on the basis of" or "based upon" the non-public information.

Another serious problem with the NYSE's proposed formulation of frontrunning is the use of the term "market" in describing the type of material, non-public information upon which trading is prohibited. We suggest that the general reference to "market" be eliminated as overly broad and, in any event, potentially inconsistent with the concept of non-public.

For example "market" information could conceivably be interpreted to include a trader's own strategy or a conclusion the trader drew from trading with other brokers or dealers, or knowledge of past or typical reactions of market participants. It could also include vague expressions of possible courses of action of a customer or other market participant. For example, a customer could call several broker dealers to discuss the possibility of entering an order for a basket of index stocks. This call theoretically could have the undesireable effect of halting trading at all firms contacted by the customer until the customer decides which firm, if any, to choose to execute the transaction previously discussed.

Consequently, we strongly urge the NYSE to consider changing the standard from "material non-public market information" to "material non-public information regarding specific customer orders" where materiality is determined by whether the customer's order was of such a time frame, magnitude and certainty that its execution could reasonably be expected to have an immediate favorable impact on the member's trade. The "time frame" should be characterized as one in which there is virtutally no risk to the firm's trading position, by virture of the impending customer order, and the subsequent unwinding of the firm position.

With regard to the issue of so called "self-frontrunning", we believe that the NYSE should not attempt to regulate such conduct through the proposed intermarket frontrunning release. Since the concept of self-frontrunning involves different considerations, and moreover represents an unwaranted expansion of traditional frontrunning concepts, prohibitions against intermarket frontrunning should be confined to trading based upon non-public customer information.

Specifically, a self-frontrunning prohibition will take the choice of markets away from traders and have the ultimate effect of depriving these markets of the capital necessary to foster liquidity. For example, under the current proposal a trader who maintained positions in two or more markets would be required to conclude, often in a matter of seconds, that any information he

EXHIBIT 2
Page 9

or the firm had in its possession was outside the scope of the frontrunning prohibitions or was not "material." The trader would have to consider such factors as the overlap between indices and the probable impact of the known transaction or order on the proposed trade. Asking traders and firms to attempt this process would effectively prevent them from trading.

We believe that concerns regarding intermarket trading by professionals can be better handled through the enforcement of existing rules on securities, options and futures exchanges which prohibit manipulative or deceptive practices based upon the concepts of intentional and/or manipulative conduct.

We have had discussions with the Chicago Mercantile Exchange ("CME") regarding their proposed intermarket frontrunning rule. These discussions have been mutually beneficial in the sense that we have had the opportunity to express, and the CME has had the opportunity to respond to, many of the same concerns contained in this letter. The CME's proposed rule interpretation (a copy of which is attached for your information and review), in our view, represents a positive approach and resolves many of the concerns raised in this letter.

Similarly, we hope that the concepts and ideas that we have expressed to you in this letter will result in the issuance of a proposed rule interpretation which will prove to be constructive overall to the markets. More importantly, we are hopeful that the exchanges can work together towards the formulation of consistent guidelines that will deter abusive conduct, but at the same time, not damage the efficiency or liquidity of the markets.

In summary, it is essential that the exchanges work in the same direction and within the same time frames in establishing their intermarket frontrunning rule interpretations. Since customer frontrunning and so called "self-frontrunning" involve different concepts, we encourage the exchanges to address each concept separately. The more pressing and least controversial proposal appears to be customer frontrunning. As a consequence, we urge you to concentrate your efforts to achieve a consensus among exchanges for this purpose. The issues concerning "self-frontrunning" are considerably more complex and involve considerations of fairness and harm about which many disagree.

We hope that you find these comments helpful and welcome the opportunity to meet with you for further discussions regarding this important subject.

Very truly yours,

Anson M. Beard, Jr.
Managing Director

Enclosure

EXHIBIT 2
Page 10

SECURITIES INDUSTRY ASSOCIATION
120 Broadway, New York, N.Y. 10271 (212) 608-1500 Facsimile: (212) 608-1604

May 13, 1988

Agnes M. Gautier, Esq.
Vice President, Market Surveillance
New York Stock Exchange, Inc.
11 Wall Street
New York, New York 10005

Re: Proposed Interpretation Prohibiting Index Futures Frontrunning

Dear Ms. Gautier:

This letter is being submitted by the Federal Regulation Committee ("Committee") of the Securities Industry Association ("SIA")[1] in response to the NYSE Information Memo, dated April 13, 1988. In that Information Memo, the New York Stock Exchange ("NYSE") stated that it "is considering the adoption of an interpretation whereby trading in index futures immediately prior to and with knowledge of the execution of one or more baskets of stock that favorably impact the value of the underlying index could constitute frontrunning and, thus, be a violation of just and equitable principles of trade."

While the Committee recognizes that certain intermarket transactions may be inappropriate and not in the public interest, the Committee is concerned that the proposed NYSE interpretation, at least as described in the Information Memo, may be overly broad and, if adopted, could adversely affect liquidity and raise significant compliance difficulties. Additionally, a

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[1] The Securities Industry Association is the trade association representing over 550 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types -- investment banks, brokers, dealers and mutual fund companies, as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America.

EXHIBIT 2
Page 11

fundamental question exists as to whether the NYSE has the authority to adopt an interpretation that would proscribe its members' conduct in a marketplace that is not regulated by the Securities and Exchange Commission. We note that the Chicago Mercantile Exchange has recently announced its intention to publish a frontrunning interpretation and we urge that the very complex subject which the NYSE interpretation proposes to address be considered in a careful, thorough and coordinated manner as an integral part of the current legislative and regulatory review of trading in options and futures on broad-based indices.

Members of this Committee have a number of concerns based on the language of the April 13 Information Memo. In our view, as described below, the proposed interpretation would appear to inhibit legitimate market transactions. Among other things, if promulgated in the form described in the Information Memo, the interpretation would appear to go beyond traditional and well understood frontrunning concepts to encompass so-called self-frontrunning, that is, situations in which a member in possession of market information regarding its own proposed transactions in a basket of stocks will execute a hedging transactions in the futures market. The interpretation also could inhibit transactions in which a member is bidding to buy or sell a large block of many different securities as an accommodation for a customer and seeks to hedge its risk in doing so. Regulating such activity would be an unprecedented expansion of frontrunning concepts.

A reasonable reading of the broad language in the Information Memo could encompass stock and futures transactions where the member is (i) acting solely as agent for a customer in buying or selling stock, (ii) buying or selling stock in principal transactions with a customer (including hedging strategies), fully disclosed in advance to its customers, or (iii) acting in a purely proprietary manner. This result would obtain without giving any consideration to whether the member's activities (a) reduce its own risks (e.g., through hedging), (b) harm the customer by misuse of information about its transactions, or (c) have been disclosed in advance to its customer. Each of these types of trading should be carefully reviewed by the NYSE before issuing a broad interpretative position that could inhibit legitimate transactions.

On April 7, 1988, our Committee submitted a comment letter to the SEC in response to the filing, last fall, of SRO frontrunning circulars and a copy is enclosed for your information. In that letter, a copy of which is enclosed for your information, the Committee indicated our concern that those proposals (i) were handled in a procedurally defective manner,

EXHIBIT 2
Page 12

foreclosing the opportunity for public comment, (ii) raise significant substantive policy issues and (iii) should be addressed in a more careful and thorough manner as part of the current legislative and regulatory review of trading in options and futures on broad-based indices. The concerns expressed in that letter are likewise applicable to so-called index futures frontrunning.

In view of the important policy and regulatory issues involved, the SIA Federal Regulation Committee strongly urges the NYSE to afford its membership the benefit of a careful review of this subject before publishing an interpretation on the subject of index futures frontrunning. Members of this Committee would appreciate the opportunity to meet with you and your staff to discuss this matter.

Sincerely yours,

Dennis H. Greenwald
Chairman
Federal Regulation Committee

2083b

cc: Richard G. Ketchum, Esq.

Information Memo

Exhibit A
Page 1

NYSE
New York
Stock Exchange, Inc.

11 Wall Street
New York, NY 10005

Market Surveillance

TO: All Members and Member Organizations

SUBJECT: New York Stock Exchange/Chicago Merchantile Exchange Intermarket Trading Restrictions

As stated in Information Memo 88-9 (April 13, 1988), program trading activity involving the purchase or sale of "baskets" of stocks on the New York Stock Exchange has raised concerns over possible trading abuses related to the execution of such program orders. In that regard, the Exchange, in conjunction with the Chicago Mercantile Exchange, has adopted the policy set forth below.

If a member or person associated with a member or member organization executes or causes to be executed, for an account in which such member or person has a direct or indirect pecuniary interest or for an account with respect to which such member or person exercises investment discretion, any transactions described below to take advantage of material, non-public information which can reasonably be expected to have an immediate, favorable impact in relation to such transactions, such member or persons may be in violation of just and equitable principles of trade (Rule 476):

(i) a transaction in any stock index futures contract, or option on a stock index future when such member or person has acquired knowledge of the imminent execution of another person's stock program transaction; or

(ii) stock program transactions, when such member or person has acquired knowledge of the imminent execution of another person's order(s) in stock index futures contracts or options on stock index futures.

In determining whether a member or person has taken advantage of material, non-public information, it is not necessary for the Exchange to demonstrate that another person has been disadvantaged. Further, such member or person may be in violation of just and equitable principles of trade regardless of whether the other person has given permission for such trading.

However, nothing herein shall prevent such member or person from establishing, in a futures market, a bona fide hedge of risk such member or person may have assumed or agreed to assume in

Exhibit A
Page 2

facilitating the execution of any other person's stock program orders. The risk to be hedged must be the result of having established a position or having given a firm commitment to assume a position, and the offsetting hedging transaction must be commensurate with such risk.

In addition, a member or person associated with a member organization who implements a proprietary market strategy involving a stock program and a related stock index futures transaction by executing the stock index futures trade(s) prior to the execution of the stock program will not be deemed to be in violation of this policy. However, if the member or person executes or causes to be executed a transaction in one market to take advantage of such member's or person's imminent transaction in a related market, that member or person may be engaging in manipulative activity.

Questions about this policy may be directed to Jack Symington, Director, Market Surveillance, (212) 656-6534, 11 Wall Street, 11th Floor, New York, New York 10005.

Robert J. McSweeney
Vice President

Information Memo

Exhibit A
Page 3

NYSE
New York
Stock Exchange, Inc.

Market Surveillance

11 Wall Street
New York, NY 10005

TO: All Members and Member Organizations

SUBJECT: New York Stock Exchange/New York Futures Exchange Intermarket Trading Restrictions

As stated in Information Memo 88-9 (April 13, 1988), program trading activity involving the purchase or sale of "baskets" of stocks on the New York Stock Exchange has raised concerns over possible trading abuses related to the execution of such program orders. In that regard, the Exchange, in conjunction with the New York Futures Exchange, has adopted the policy set forth below.

If a member or person associated with a member or member organization executes or causes to be executed, for an account in which such member or person has a direct or indirect pecuniary interest or for an account with respect to which such member or person exercises investment discretion, any transactions described below to take advantage of material, non-public information which can reasonably be expected to have an immediate, favorable impact in relation to such transactions, such member or persons may be in violation of just and equitable principles of trade (Rule 476):

(i) a transaction in any stock index futures contract, or option on a stock index future when such member or person has acquired knowledge of the imminent execution of another person's stock program transaction;

(ii) stock program transactions, when such member or person has acquired knowledge of the imminent execution of another person's order(s) in stock index futures contracts or options on stock index futures; or

(iii) a transaction in any stock index option, when such member or person has acquired knowledge of the imminent execution of another person's order(s) in stock index futures contracts or options on a stock index future.

In determining whether a member or person has taken advantage of material, non-public information, it is not necessary for the Exchange to demonstrate that another person has been disadvantaged. Further, such member or person may be in violation of just and equitable principles of trade regardless of whether the other person has given permission for such trading.

Exhibit A
Page 4

However, nothing herein shall prevent such member or person from establishing, in a futures market, a bona fide hedge of risk such member or person may have assumed or agreed to assume in facilitating the execution of any other person's stock program or stock index option orders. The risk to be hedged must be the result of having established a position or having given a firm commitment to assume a position, and the offsetting hedging transaction must be commensurate with such risk.

In addition, a member or person associated with a member organization who implements a proprietary market strategy involving a stock program or stock index option transaction(s) and a related stock index futures transaction by executing the stock index futures trade(s) prior to the execution of the stock program or the stock index option transaction(s) will not be deemed to be in violation of this policy. However, if the member or person executes or causes to be executed a transaction in one market to take advantage of such member's or person's imminent transaction in a related market, that member or person may be engaging in manipulative activity.

Questions about this policy may be directed to Jack Symington, Director, Market Surveillance, (212) 656-6534, 11 Wall Street, 11th Floor, New York, New York 10005.

Robert J. McSweeney
Vice President

News

NYSE
New York
Stock Exchange, Inc.

Contact: Sharon Gamsin
(212) 656-8222

Catherine Maroney
(212) 656-2065

For Release: Immediately
Thursday,
June 1, 1989

11 Wall Street
New York, NY 10005

NEW YORK STOCK EXCHANGE BOARD APPROVES FIRST PORTFOLIO PRODUCT BASED ON STOCK OWNERSHIP

Exchange Stock Portfolio Trading Could Begin in September

NEW YORK, June 1 -- The first product for the single-execution trading of a portfolio of stocks providing for the ownership of the underlying equities was approved by the New York Stock Exchange board of directors today.

NYSE chairman and chief executive officer John J. Phelan Jr. said the Exchange Stock Portfolio is designed to meet a growing customer need for a standardized portfolio of stocks that can be executed in a single transaction.

Efficient, Cost-Effective Transactions

The Exchange stock portfolio will be a capitalization-weighted basket of stocks based on the Standard & Poor's 500 Index. It will allow for the efficient, cost-effective purchase or sale of a large basket of stocks.

Unlike trading in cash-settled index products, an Exchange stock portfolio trade will provide the buyer the benefits of owning each of the equities in the index.

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Mr. Phelan pointed out that several studies following the October 1987 market break recommended that the NYSE develop a product to trade an equities portfolio. Both the SEC and a study of program trading conducted by former U.S. attorney general Nicholas Katzenbach urged that the Exchange stock portfolio product provide for physical delivery of the underlying equities.

"The Exchange stock portfolio approved today by the NYSE board of directors incorporates those recommendations, and should meet the needs of our customers," Mr. Phelan said.

In developing the Exchange stock portfolio, the NYSE worked closely with members of the Pension Managers Advisory Committee, member firms active in portfolio trading, and its trading floor community. Institutional investors have expressed the need for a product that offers cost-efficiency, liquidity, and price certainty.

Based on Standard & Poor's 500 Index

Exchange stock portfolio's will be based on the S&P 500, which will be converted into a trading vehicle by rounding its fractional shares in each stock to the nearest whole share.

This creates a deliverable portfolio with an initial value of approximately $5 million, containing 462 NYSE listed and 38 non-NYSE stocks. The portfolio will trade in decimals, with a minimum variation of .01 index points.

The NYSE's Exchange stock portfolio's could begin trading in September, pending approval by the Securities and Exchange Commission. The NYSE will submit a wide range of rules governing the market structure and trading of Exchange stock portfolio's to the SEC for approval.

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New Trading Features

While many of the features of the NYSE market system and existing auction market rules apply to the trading of Exchange stock portfolios, a number of new procedures and rules will be adopted for this product to assure a viable, liquid market.

A market structure consisting of competitive stock portfolio market makers, NYSE specialists, brokers and a book broker/dealer will support trading in Exchange stock portfolio's.

A new entity, a book broker/dealer, will participate by presiding over all Exchange stock portfolio trading and also will effect transactions in the 38 non-NYSE listed stocks in the portfolio.

Members and member firms may register as competitive Exchange stock portfolio market makers, to provide the expertise and capital they employ in buying and selling stock portfolios and make continuous two-sided quotations in the portfolio.

The specialist community will participate as a market maker by aggregating their current published quotation in individual S&P 500 stocks. These quotes will be combined with a quote from the book broker/dealer in a "mini basket" of the 38 non-NYSE stocks to create an aggregate quote for the portfolio.

Other NYSE members and member firms will act as agents executing customer orders.

"The market structure is devised to ensure a combination of upstairs and downstairs participation," Mr. Phelan said.

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Trading Rules Unique to Exchange Stock Portfolios

The NYSE will submit to the SEC for approval a series of rules specific to Exchange stock portfolio trading. These will relate to:

- integration of competitive market makers and specialists
- open limit-order book
- priority based on time and price
- new crossing procedures
- trading customized stock portfolios
- exemption from short sale rule
- Index-On-Close orders
- use of a call market in times of market stress

The NYSE's portfolio trading system will consist of on and off floor order entry terminals, allowing participants to enter orders and view the limit order book and activity files. All bids, offers and trades in Exchange stock portfolio's will be disseminated to the public.

All Exchange stock portfolio trades will be subject to same-day comparison and settlement will occur on the fifth day, similar to any other stock.

# # # #

07770

OFFICE OF
THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON DC 20549

May 17, 1989

The Honorable Christopher J. Dodd
Chairman
Securities Subcommittee
SD-534 Dirksen Senate
Office Bldg.
Washington, D.C. 20510

Dear Chairman Dodd:

Thank you again for introducing, along with Senator John Heinz on March 17, 1989, a market reform bill (S. 648, The Market Reform Act of 1989) based on the legislative package submitted by the Securities and Exchange Commission to the 100th Congress in June, 1988.

The legislative package submitted by the Commission in June 1988 contained four separate proposals relating to: (1) emergency powers for the SEC, (2) clearance and settlement, (3) large trade reporting and (4) risk assessment for financial holding companies. S. 648 contains these four proposals in essentially the form submitted by the Commission.

Subsequent to the Commission's June 1988 submission, the Commission received useful comments from the staff of the Commodity Futures Trading Commission and the staff of the Board of Governors of the Federal Reserve System. In light of these comments, the Commission has redrafted the language of the "large trader reporting" and "risk assessment" provisions, Sections 3 and 4, respectively, of S. 648. The Commission supports the adoption of S. 648. However, the Commission believes that the enclosed modified statutory language and legislative history for Sections 3 and 4 of S. 648 respond to the concerns raised by the staffs of our sister agencies in the Fall of 1988 and constitute appropriate amendments to the pending legislation. The proposed amendments to Sections 3 and 4 of S.648 also respond to concerns raised by the Securities Industry Association in the Fall of 1988. For ease of review, we have enclosed both a "clean" and a "red-lined" version of redrafted Sections 3 and 4.

The enclosed materials are also being transmitted simultaneously to other members of the Presidential Working Group on Financial Markets, who have previously received, but have not formally discussed, earlier drafts of the proposed modifications. The members of the Working Group have not expressed views on these proposals.

The views expressed here and in the enclosed materials are those of the Commission and do not necessarily express the views of the President. These materials are being submitted simultaneously to the Office of Management and Budget. We will inform you of any advice received from OMB concerning the relationship of these materials to the program of the administration.

Questions concerning the proposed legislation may be directed to Nina Gross, Director of Legislative Affairs (272-2500).

Sincerely yours,

David S. Ruder

David S. Ruder
Chairman

cc: Office of Management and Budget

Enclosures

A. Text of modified Section 3 of S. 648, "large trader reporting" provisions and legislative history.

B. Text of modified Section 4 of S. 648, "risk assessment" provisions and legislative history.

Redrafted "large trader reporting" provision, Section 3 of S. 648, and legislative history.

"Clean" Draft

Modified Version for S. 648

Sec.3. LARGE TRADER REPORTING.

Section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m) is amended by adding at the end the following:

"(h)(1) For the purpose of monitoring the impact on the securities markets of securities transactions involving a substantial volume or a large fair market value or exercise value, every person who, for his own account or an account for which he exercises investment discretion, effects transactions for the purchase or sale of any publicly traded securities or options by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of a national securities exchange, during any 24-hour period in an amount equal to or in excess of such amount as shall be fixed from time to time by the Commission, shall file reports regarding such transactions with the Commission, or any self-regulatory organization as the Commission shall designate by rule, regulation, or order to receive such reports. Reports required under this subsection shall be filed at such times, and include such information with respect to any transaction or series of transactions subject to this subsection, as the Commission by rule, regulation, or order may prescribe.

"(2) For purposes of this subsection --

"(A) the term 'publicly traded securities or options' means any equity securities, including options on individual equity securities, and options on a group or index of such securities, listed, or admitted to unlisted trading privileges, on a national securities exchange, or quoted in an automated inter-dealer quotation system; and

"(B) two or more persons acting as a partnership, limited partnership, syndicate, or other group, for the purpose of effecting transactions described in paragraph (1) of this subsection, shall be deemed a 'person'.

(3) The Commission may prescribe rules governing the manner in which transactions and accounts shall be aggregated for the purpose of paragraph (1) of this subsection.

(4) Notwithstanding the provisions of section 552 of title 5, United States Code or of any other law, the Commission (or any other Federal department or agency) shall not be compelled to disclose any information required to be reported under this subsection. Nothing in this subsection shall prevent the Commission from complying with a request for information from a duly authorized committee or subcommittee of the Congress, or any other Federal department or agency requesting the information for purposes within the scope of its jurisdiction, or complying with an order of a court of the United States in an action commenced by the United States or the Commission.

"(5) The Commission by rule, regulation or order, may exempt any person or classes of persons or any transaction or classes of transactions, either conditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection, and the rules and regulations thereunder.".

Large Trader Reporting

This section is designed to assist the Commission in its surveillance of the U.S. securities markets, clarifying and expanding its broad authority to adopt reporting rules for the purpose of monitoring the impact on the securities markets of large transactions in publicly traded securities involving a substantial volume or a large fair market value or exercise value. The section only applies to transactions effected using the U.S. jurisdictional means (including transactions on a national securities exchange). The Commission is authorized to adopt rules requiring any person effecting such large transactions for its own account, or for an account for which it exercises investment discretion, to file reports with the Commission, or with a self-regulatory organization designated by the Commission. The Commission and each self-regulatory organization could use information contained in these reports for surveillance, enforcement, and other appropriate regulatory purposes. Consistent with the long history of self-regulation in the U.S. securities markets, in determining the manner in which to implement this reporting authority, the Commission will consider, among other factors, the adequacy of self-regulatory organizations' large trader reporting requirements.

The section applies to large transactions, or series of transactions, in "publicly traded securities or options." Large traders include, among others, individuals, banks, broker-dealers, insurance companies, investment advisors, mutual funds, pension funds, and trust companies. The Commission will take into account relevant differences among reporting entities in establishing reporting requirements. The term "publicly traded securities or options" is defined in the section to mean any equity security, including options on individual equity securities, and options on an index or group of equity securities, listed, or admitted to unlisted trading privileges on a national securities exchange, or quoted in an automated inter-dealer quotation system. The Commission understands that parameters must be set for reporting securities and filing large trader reports.

The Commission would also be authorized to adopt rules prescribing the manner in which transactions and accounts would be aggregated for the purposes of this section. Generally, aggregation of accounts among different broker-dealers could occur at the self-regulator level or at the Commission.

Two or more persons acting as a partnership, limited partnership, syndicate or other group for the purpose of trading, acquiring, holding or disposing of publicly traded securities or options would be considered a "person." The section would permit the Commission by rule, regulation or order, to exempt any person, transactions, or classes of persons or transactions, either conditionally or upon specified terms and conditions or for stated periods of time, from the operation of this section and the rules and regulations thereunder.

In adopting rules pursuant to its authority under this section, the Commission would take into account whether other means of obtaining the relevant information are available. Every effort would be made by the Commission to minimize the economic burdens of reporting and to utilize existing data streams whenever possible. Moreover, the costs and benefits of beneficial ownership reporting would be carefully considered, and the Commission would not impose requirements on broker-dealers to report beneficial ownership information that is not recorded in the normal course of business.

With respect to foreign persons or accounts, the Commission expects to continue its current program of negotiating memoranda of understanding with foreign governments and would seek to include within such agreements the exchange of trading information for investigatory purposes. The Commission generally would not seek to use its authority under this section to obtain information concerning foreign persons or accounts under the jurisdiction of a foreign government if the Commission has entered into an agreement for sharing investigatory information with that government.

The Commission (or any other Federal department or agency) could not be compelled to disclose publicly any information required to be reported under this section for which disclosure might otherwise be required pursuant to the Freedom of Information Act, 5 U.S.C. 552, or of any other law. However, the Commission is not prevented under this section from complying with information requests from Congress, any other Federal department or agency requesting the information for purposes within the scope of its jurisdiction, or a court of the United States in any action commenced by the United States or the Commission.

The Commission in adopting any direct reporting rule or rules will carefully consider the total impact of the rule or rules on capital formations in the United States, and the relationship between our domestic markets and the international market place for securities. The free flow of capital has been a long-standing national policy, and should not be impeded by rules or regulations adopted under this section.

Redrafted "large trader reporting" provision, Section 3 of S. 648, and legislative history.

"Red-Lined" Draft

Modified Version for S. 648
Bracked material deleted / underlined material inserted

Sec.3. LARGE TRADER REPORTING.

Section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m) is amended by adding at the end the following:

"(h)(1) For the purpose of monitoring the impact on the securities markets of securities transactions involving a substantial volume or a large fair market value or exercise value, [and related transactions in equity index futures and options on such futures,] every person who, for his own account or an account for which he exercises investment discretion, [effects--

"(A) transactions for the purchase or sale of any publicly traded securities or options, or

" (B) transactions in contracts of sale (or options on such contracts) for future delivery of a group or index of publicly traded securities (or any interest therein or based on the value thereof) that are related to transactions in publicly traded securities or options,]

effects transactions for the purchase or sale of any publicly traded securities or options by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of a national securities exchange [or board of trade], during any 24-hour period in an amount equal to or in excess of such amount as shall be fixed from time to time by the Commission, shall file reports regarding such transactions with the Commission, or any self-regulatory organization as the

Commission shall designate by rule, regulation, or order to receive such reports. Reports required under this subsection shall be filed at such times, and include such information with respect to any transaction or series of transactions subject to this subsection, as the Commission by rule, regulation, or order may prescribe.

"(2) For purposes of this subsection --

"(A) the term 'publicly traded securities or options' shall mean[s] any equity securities, including options on individual equity securities, and options on a group or index of such securities, listed, or admitted to unlisted trading privileges, on a national securities exchange, or quoted in an automated inter-dealer quotation system; and

"(B) two or more persons acting as a partnership, limited partnership, syndicate, or other group, for the purpose of effecting transactions described in paragraph (1) of this subsection, shall be deemed a 'person'.

(3) The Commission may prescribe rules governing the manner in which transactions and accounts shall be aggregated for the purpose of paragraph (1) of this subsection.

(4) Notwithstanding the provisions of section 552 of title 5, United States Code or of any other law, the Commission (or any other Federal department or agency) shall not be compelled to disclose any information required to be reported under this subsection [.] ; Provided, however, That [N]nothing in this subsection shall prevent the Commission from complying with a request for information from a duly authorized committee or

subcommittee of the Congress, or any other Federal department or agency requesting the information for purposes within the scope of its jurisdiction, or complying with an order of a court of the United States in an action commenced by the United States or the Commission.

"(5) The Commission by rule, regulation or order, may exempt any person or classes of persons or any transaction or classes of transactions, either conditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection, and the rules and regulations thereunder.".

Large Trader Reporting

This section [is modeled after the large trader reporting authority of the Commodity Futures Trading Commission and] is designed to assist the Commission in its surveillance of the U.S. securities markets, [by providing it with] clarifying and expanding its broad authority to adopt reporting rules for the purpose of monitoring the impact on the securities markets of large transactions in publicly traded securities involving a substantial volume or a large fair market value or exercise value [,and related transactions in equity index futures and options on such futures.]. The section only applies to transactions effected using the U.S. jurisdictional means (including transactions on a national securities exchange). The Commission is authorized to adopt rules requiring any person effecting such large transactions for its own account, or for an account for which it exercises investment discretion, to file reports with the Commission, or with a self-regulatory organization designated by the Commission. The Commission and each self-regulatory organization could use information contained in these reports for surveillance, enforcement, and other appropriate regulatory purposes. Consistent with the long history of self-regulation in the U.S. securities markets, in determining the manner in which to implement this reporting authority, the Commission will consider, among other factors, the adequacy of self-regulatory organizations' large trader reporting requirements.

The section applies to large transactions, or series of transactions, in "publicly traded securities or options." [and related transactions in futures on such securities and options thereon.] Large traders include, among others, individuals, banks, broker-dealers, insurance companies, investment advisors, mutual funds, pension funds, and trust companies. The Commission will take into account relevant differences among reporting entities in establishing reporting requirements. The term "publicly traded securities or options" is defined in the section to mean any equity security, including options on individual equity securities, and options on an index or group of equity securities, listed, or admitted to unlisted trading privileges on a national securities exchange, or quoted in an automated inter-dealer quotation system. The Commission understands that parameters must be set for reporting securities and filing large trader reports.

The Commission would also be authorized to adopt rules prescribing the manner in which transactions and accounts would be aggregated for the purposes of this section. Generally, aggregation of accounts among different broker-dealers could occur at the self-regulator level or at the Commission.

Two or more persons acting as a partnership, limited partnership, syndicate or other group [, including joint trading accounts,] for the purpose of trading, acquiring, holding or disposing of publicly traded securities or options would be considered a "person." The section would permit the Commission by rule, regulation or order, to exempt any person, transactions, or classes of persons or transactions, either conditionally or upon specified terms and conditions or for stated periods of time, from the operation of this section and the rules and regulations thereunder.

In adopting rules pursuant to its authority under this section, the Commission would take into account whether other means of obtaining the relevant information are available. [In this connection, the Commission would consult with the CFTC in order to avoid duplicative reporting whenever practical.] Every effort would be made by the Commission to minimize the economic burdens of reporting and to utilize existing data streams whenever possible. Moreover, the costs and benefits of beneficial ownership reporting would be carefully considered, and would not impose requirements on broker-dealers to report beneficial ownership information that is not recorded in the normal course of business.

With respect to foreign persons or accounts, the Commission expects to continue its current program of negotiating memoranda of understanding with foreign governments and would seek to include within such agreements the exchange of trading information for investigatory purposes. The Commission generally would not seek to use its authority under this section to obtain information concerning foreign persons or accounts under the jurisdiction of a foreign government if the Commission has entered into an agreement for sharing investigatory information with that government.

The Commission (or any other Federal department or agency) could not be compelled to disclose publicly any information required to be reported under this section for which disclosure might otherwise be required pursuant to the Freedom of Information Act, 5 U.S.C. 552, or of any other law. However, the Commission is not [authorized under this section to withhold information] prevented under this section from complying with information requests from Congress, any other Federal department or agency requesting the information for purposes within the scope of its jurisdiction, or a court of the United States in any action commenced by the United States or the Commission.

The Commission in adopting any direct reporting rule or rules will carefully consider the total impact of the rule or rules on capital formations in the United States, and the relationship between our domestic markets and the international market place for securities. The free flow of capital has been a long-standing national policy, and should not be impeded by rules or regulations adopted under this section.

Redrafted "risk assessment" provision,
Section 4 of S. 648,
and legislative history.

"Clean" Draft

Modified Version for S.648

SEC.4. RISK ASSESSMENT FOR HOLDING COMPANY SYSTEMS.

Section 17 of the Securities Exchange Act of 1934 (15 U.S.C. 78q) is amended by adding at the end the following:

"(h)(1) Every person who is (A) a registered broker or dealer, or (B) a government securities broker, government securities dealer, or municipal securities dealer for which the Commission is the appropriate regulatory agency, shall make such reports as the Commission, by rule, regulation or order, prescribes concerning any transaction, agreement, contract, arrangement, or event (or any series or combination thereof) of or related to any of its associated persons, other than a natural person, that the Commission determines will have or is reasonably likely to have a material impact on the financial or operational condition of such person. Reports prescribed by the Commission under this section may include, but shall not be limited to, information concerning assets, liabilities, contingent liabilities, material contracts, loan commitments, trading or investment positions, lines of credit, letters of credit, and financial guarantees.

"(2) No information shall be required of any person subject to paragraph (1) of this subsection regarding any associated person that is--

"(A) a financial institution as defined in Section 3(a)(46) of this title;

"(B) a bank holding company, as defined in section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C.

1841(a)) and any subsidiary (other than a registered broker or dealer) of such a bank holding company;

"(C) a savings and loan holding company, as defined in section 408(a)(1)(D) of the National Housing Act (12 U.S.C. 1730a(a)(1)(D);

"(D) an insurance company, as defined in section 2(13) of the Securities Act of 1933 (15 U.S.C. 77b(13)); or

"(E) a futures commission merchant or introducing broker as defined in section 2 of the Commodity Exchange Act (7 U.S.C. 2);

so long as a supervisory agency as defined in section 1101 of the Financial Right to Privacy Act of 1978 (12 U.S.C. 3401(6)), a State insurance commission or similar State agency, or the Commodity Futures Trading Commission has the authority to collect information substantially similar to that required to be included in reports under paragraph (1) of this section.

"(3) The Commission, by rule, regulation or order, may exempt any person or classes of persons, either conditionally or upon specified terms and conditions or for stated periods, from the provisions of this subsection, and the rules and regulations thereunder. In granting such exemptions, the Commission may consider, among other factors, the primary business of any associated person, the nature and extent of domestic or foreign regulation of the associated person's activities and, with respect to the person required to report pursuant to this subsection and its associated persons, on a consolidated basis, the proportion of assets devoted to, and revenues derived from, activities in the United States securities markets.

"(4) Notwithstanding the provisions of section 552 of title 5, United States Code (popularly known as the Freedom of Information Act) or of any other law, the Commission (or any other Federal department or agency) shall not be compelled to disclose any information required to be reported under this subsection, or any similar information relating to the financial or operational condition of any associated person of (A) a registered broker or dealer or (B) a government securities broker, government securities dealer, or municipal securities dealer for which the Commission is the appropriate regulatory agency, supplied to the Commission by any domestic or foreign regulatory agency; Provided, however, That nothing in this subsection shall prevent the Commission from complying with a request for information from a duly authorized committee or subcommittee of the Congress, any other Federal department or agency requesting the information for purposes within the scope of its jurisdiction, or complying with an order of a court of the United States in an action commenced by the United States or the Commission.".

Risk Assessment For Holding Company Systems

This section would enable the Commission to adopt rules requiring brokers and dealers, and government securities brokers, government securities dealers, and municipal securities dealers for which the Commission is the appropriate regulatory agency, to provide reports regarding the activities of associated persons that have the potential materially to affect the financial or operational condition of such entities. The section would permit the Commission to require information concerning, among other things, assets, liabilities, contingent liabilities, material contracts, loan commitments, trading or investment positions, lines of credit, letters of credit, and financial guarantees.

The section would not require information to be provided concerning the activities of any natural person. In addition, information would not be required relating to certain classes of regulated entities. Specifically, information regarding the activities of banks (including foreign banks), savings and loan associations, bank holding companies (and their subsidiaries which are not registered brokers or dealers), savings and loan holding companies, insurance companies, futures commission merchants and introducing brokers would not need to be provided directly to the Commission, so long as a regulatory agency has the authority to collect information similar to the information the Commission may collect under this section.

In addition to enumerating classes of entities for whom information need not be provided directly to the Commission, the section permits the Commission to provide exemptions from the reporting requirements either conditionally or upon specified terms and conditions or for stated periods. Among other things, this provision would allow the Commission to exclude from the reporting requirement any information regarding diversified holding companies and international financial organizations that do not devote a significant portion of their consolidated assets to activities in the U.S. securities markets. The section also notes that in granting exemptions, the Commission may consider the primary business of any associated person, and the nature and extent of domestic or foreign regulation of the associated person's activities. Thus, for example, the Commission may wish to exclude small broker-dealers from the reporting requirements, or not to require information concerning holding companies or their affiliates who are primarily engaged in non-financial activities, such as merchandising or manufacturing, or major foreign banks whose subsidiaries or affiliates include a U.S. broker-dealer.

The Commission (or any other Federal department or agency) could not be compelled to disclose publicly any information required to be reported under this section for which disclosure might otherwise be required pursuant to the Freedom of

Information Act, 5 U.S.C. 552, or any other laws. However, the Commission is not prevented under this section from providing information to Congress, any other Federal department or agency requesting the information for purposes within the scope of its jurisdiction or a court of the United States in an action commenced by the United States or the Commission.

Redrafted "risk assessment" provision, Section 4 of S. 648, and legislative history.

"Red-Lined" Draft

Modified Version for S.648
Bracketed material deleted / underlined material inserted

SEC.4. RISK ASSESSMENT FOR HOLDING COMPANY SYSTEMS.

Section 17 of the Securities Exchange Act of 1934 (15 U.S.C. 78q) is amended by adding at the end the following:

"(h)(1) [For the purpose of monitoring the financial and operational condition of persons subject to this section, and to provide greater protection for investors,] [e]Every person who is (A) a registered broker or dealer, or (B) a government securities broker, government securities dealer, or municipal securities dealer for which the Commission is the appropriate regulatory agency, shall make such reports as the Commission, by rule, regulation or order, prescribes concerning any [aspect of the financial or operational condition] transaction, agreement, contract, arrangement, or event (or any series or combination thereof) of or related to any of its associated persons, other than a natural person, that the Commission determines will have or is reasonably likely to have a material impact on the financial or operational condition of such person. Reports prescribed by the Commission under this section may include, but shall not be limited to, information concerning assets, liabilities, contingent liabilities, material contracts, loan commitments, trading or investment positions, lines of credit, letters of credit, and financial guarantees.

"(2) No information shall be required of any person subject to paragraph (1) of this subsection regarding any associated person that is--

"(A) a financial institution as defined in Section 3(a)(46) of this title;

"(B) a bank holding company, as defined in section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a)) and any subsidiaries (other than a registered broker or dealer) of such a bank holding company;

"(C) a savings and loan holding company, as defined in section 408(a)(1)(D) of the National Housing Act (12 U.S.C. 1730a(a)(1)(D);

"(D) an insurance company, as defined in section 2(13) of the Securities Act of 1933 (15 U.S.C. 77b(13)); or

"(E) a futures commission merchant or introducing broker as defined in section 2 of the Commodity Exchange Act (7 U.S.C. 2);

[if information substantially similar to that required to be included in reports under paragraph (1) of this subsection is available to] so long as a supervisory agency as defined in section 1101 of the Financial Right to Privacy Act of 1978 (12 U.S.C. 3401(6)), a State insurance commission or similar State agency, or the Commodity Futures Trading Commission [.] has the authority to collect information substantially similar to that required to be included in reports under paragraph (1) of this section.

"(3) The Commission, by rule, regulation or order, may exempt any person or classes of persons, either conditionally or upon specified terms and conditions or for stated periods, from the provisions of this subsection, and the rules and regulations thereunder. In granting such exemptions, the Commission [shall] may consider, among other factors, the primary business of any associated person, the nature and extent of domestic or foreign regulation of the associated person's activities and, with respect to the person required to report pursuant to this subsection and its associated persons, on a consolidated basis, the proportion of assets devoted to, and revenues derived from, activities in the United States [financial] securities markets.

"(4) Notwithstanding the provisions of section 552 of title 5, United States Code or of any other law, the Commission (or any other Federal department or agency) shall not be compelled to disclose any information required to be reported under this subsection [.] , or any similar information relating to the financial or operational condition of any associated person of (A) a registered broker or dealer or (B) a government securities broker, government securities dealer, or municipal securities dealer for which the Commission is the appropriate regulatory agency, supplied to the Commission by any domestic or foreign regulatory agency: Provided, however, That [N]nothing in this subsection shall prevent the Commission from complying with a request for information from a duly authorized committee or subcommittee of the Congress, any other Federal department or agency requesting the information for purposes within the scope of its jurisdiction, or complying with an order of a court of the United States in an action commenced by the United States or the Commission.".

Risk Assessment For Holding Company Systems

This section would [enhance the Commission's ability to monitor the financial and operational condition of] enable the Commission to adopt rules requiring brokers and dealers, and government securities brokers, government securities dealers, and municipal securities dealers for which the Commission is the appropriate regulatory agency, [by clarifying the Commission's authority to require] to provide reports regarding the activities of associated persons that have the potential materially to affect the financial or operational condition of such entities. The section would permit the Commission to [adopt rules requiring] require information concerning, among other things, assets, liabilities, contingent liabilities, material contracts, loan commitments, trading or investment positions, lines of credit, letters of credit, and financial guarantees.

The section would not require information to be provided concerning the activities of any natural person. In addition, information would not be required relacing to certain classes of regulated entities. Specifically, information regarding the activities of banks (including foreign banks), savings and loan associations, bank holding companies (and their subsidiaries which are not registered brokers or dealers), savings and loan holding companies, insurance companies, futures commission merchants and introducing brokers would not need to be provided directly to the Commission, so long as [similar information is available to a supervisory agency as defined in 12 U.S.C. 3401(6), a state insurance commission or similar state agency, or the Commodity Futures Trading Commission.] a regulatory agency has the authority to collect information similar to the information the Commission may collect under this section.

In addition to enumerating classes of entities for whom information need not be provided directly to the Commission, the section permits the Commission to provide exemptions from the reporting requirements either conditionally or upon specified terms and conditions or for stated periods. Among other things, this provision would allow the Commission to exclude from the reporting requirement any information regarding diversified holding companies and international financial organizations that do not devote a significant portion of their consolidated assets to activities in the U.S. [financial] securities markets. The section also notes that in granting exemptions, the Commission may consider the primary business of any associated person, and the nature and extent of domestic or foreign regulation of the associated person's activities. Thus, for example, the Commission may wish to exclude small broker-dealers from the reporting requirements, or not to require information concerning holding companies or their affiliates who are primarily engaged in non-financial activities, such as merchandising or manufacturing, or major foreign banks whose subsidiaries or affiliates include a U.S. broker-dealer.

The Commission (or any other Federal department or agency) could not be compelled to disclose publicly any information required to be reported under this section for which disclosure might otherwise be required pursuant to the Freedom of Information Act, 5 U.S.C. 552, or any other laws. However, the Commission is not [authorized] prevented under this section [to withhold] from providing information [from] to Congress, any other Federal department or agency requesting the information for purposes within the scope of its jurisdiction or a court of the United States in an action commenced by the United States or the Commission.

The First Boston Corporation
Park Avenue Plaza
New York, New York 10055
Telephone: 212/909-2626

First Boston

Michael Raoul-Duval
Managing Director

July 6, 1989

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities
Senate Committee on Banking, Housing and Urban Affairs
444 Russell Senate Office Building
Washington, D.C. 20510-0702

Re: S. 648, Market Reform Act of 1989

Dear Mr. Chairman:

The First Boston Corporation is pleased to provide its views concerning the "Market Reform Act of 1989," S.648, 101st Cong., 1st Sess. (Mar. 17, 1989), a bill that was introduced by you at the request of the Securities and Exchange Commission ("SEC"). The bill is intended to respond to concerns raised by the October 1987 market break ("Market Break").

While First Boston strongly supports efforts to ensure that the events of the Market Break do not recur, it is troubled by two of the bill's sections:

- The first would give the SEC authority to monitor the financial and operational condition of broker-dealer holding company systems. First Boston does not believe that such an expansion of SEC jurisdiction is needed to respond to the Market Break. Nothing occurred during the Market Break to suggest that broker-dealers and their customers are at risk as the result of activities undertaken by broker-dealer affiliates. The SEC's Division of Market Regulation concluded, prior to the Market Break, that the agency's net capital rule provides adequate insulation from risks undertaken by broker-dealer affiliates. We are aware of no event occurring during the Market Break that undermines this conclusion.

- The second would authorize the SEC to require investors to file transaction reports concerning large trades. While this provision responds to the Break, it goes beyond what is reasonably necessary. The SEC now has ready access to information about large traders as the result of cooperative SEC-self regulatory organization ("SRO") efforts to develop a universal, automated "blue sheeting" system. To the extent that necessary information may not be included within the system, First Boston agrees with the position of the New York Stock Exchange that it should be collected and stored in a member firm's file and made available to an SRO or the SEC only upon request for a specific purpose, such as an authorized insider trading investigation or market study.

First Boston's views are discussed in more detail below.

1. Section 4: Risk Assessment For Holding Company Systems

Section 4 of the bill, captioned "Risk Assessment For Holding Company Systems," would give the SEC jurisdiction to require registered brokers and dealers to file reports with the SEC concerning "any aspect of the financial or operational condition of [their] associated persons ... that the Commission determines" may be material to the broker's or dealer's financial or operational condition. The term "associated person" encompasses holding companies owning broker-dealers as well as the affiliates and subsidiaries of broker-dealers. The purpose of this new authority is to enable the SEC to monitor the finances and operations of the entire holding company system surrounding a broker-dealer, and not merely the broker-dealer itself.

a. The Lack of Demonstrated Need For Monitoring Jurisdiction

First Boston could not agree more that assuring that our broker-dealer firms have adequate capital is vitally important to investor confidence in our markets. Our markets would be harmed by the mere perception, correct or incorrect, among investors that firms are inadequately capitalized to protect their customers from the risk of insolvency. However, First Boston does not agree that it is necessary to give the SEC monitoring authority over broker-dealer affiliates in order protect investors or maintain their confidence in the solvency of broker-dealer firms.

The SEC's Division of Market Regulation concluded, prior to the Market Break, that the agency's net capital rule is adequate to ensure that the problems of affiliates do not spill over onto broker-dealers and their customers.1/ The net capital rule

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1/ Memorandum from Richard Ketchum to Chairman John Shad,
(continued...)

prohibits capital from being withdrawn from a registered broker-dealer by a stockholder or partner if to do so would reduce its net capital below early warning levels set by the SEC (which are in excess of minimum net capital requirements).[2] "It thus provides," the SEC's staff has noted, "a prohibition against the withdrawal of capital to benefit an affiliate experiencing financial difficulty if such withdrawal could possibly endanger a registered broker-dealer's stability."[3] The net capital rule also effectively precludes a registered broker-dealer from making unsecured loans to affiliates where such loans would reduce its net capital below the minimum required.[4] Indeed, the rule requires a broker-dealer to deduct from net capital any receivable owed to it by an affiliate, even if it is fully secured, unless "the books and records of the affiliate are made available for examination when requested by the Commission ... in order to demonstrate the validity of the receivable ... ."[5] Thus, the net capital rule ensures that, whenever there are dealings between a broker-dealer and one of its affiliates that

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1/(...continued)
"Response to Chairman Dingell's letter Dated April 3, 1986," May 30, 1986, at 4 (The Division believes that the "current statutory and regulatory ... requirements are adequate to protect the public and the markets" from the risks of lending conducted by separate affiliates of broker-dealers); Memorandum from Richard Ketchum to Acting Chairman Charles Cox, "Response to Chairman Dingell's letter Dated May 27, 1987," June 24, 1987, at 3 ("The Division continues to believe that ...these rules should ensure the financial viability of the broker-dealer entity").

[2] Rule 15c3-1(e), 17 C.F.R. 240.15c3-1(e).

[3] "Internationalization of the Securities Markets," Report of the Staff of the SEC to the Senate Comm. on Banking, Housing and Urban Affairs and the House Comm. on Energy and Commerce, July 27, 1987, at V-39 ("Internationalization").

[4] A loan to an affiliate must be deducted from a broker-dealer's net capital unless it is fully secured. Rules 15c3-1(c)(2)(iv)(B), 15c3-1(c)(2)(iv)(H).

[5] Rule 15c3-1(c)(2)(iv)(H), 17 C.F.R. 240.15c3-1(c)(iv)(H). See also Internationalization, *supra*, at V-40 ("Unsecured receivables from an affiliated company are not deemed to be includable assets for net capital purposes" and "any secured receivable from an unregistered affiliate [must] be deducted from net worth unless the affiliate makes available upon request its books and records to the Commission ...").

could even possibly impair the broker-dealer's capital position, the SEC has the ability to examine the operational and financial position of the affiliate.

Nothing took place during the Market Break which raised substantial questions concerning the adequacy of the SEC's net capital and customer protection rules.6/ No large firm failed during the Market Break. Indeed, despite losses totalling almost $700 million, each of 15 largest investment banking and integrated retail firms "remained above the early warning levels ..." set by the SEC's net capital rule.7/ Thus, it is not surprising that the SEC Market Break Study concluded that "the net capital rule adequately measures the actual and contingent risks for securities firms. The capital required by the net capital rule and broker-dealers' substantial excess net capital provided a reasonable safety margin during the October market break ... ."8/ The NYSE's study likewise concluded, "[a]ll things considered, current regulations assuring the financial integrity of the securities ... markets would seem to be adequate."9/

While there were, of course, concerns that a major firm might fail as the result of the Market Break, these concerns related to the activities of broker-dealer firms themselves -- not those of their affiliates. The SEC's Market Break study noted three major concerns relating to the financial condition of broker-dealer firms: (i) the potential that some firms may have suffered such enormous losses in connection with their

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6/ The Market Break did reveal that specialist capital requirements should be increased. This problem is already being addressed by the SEC, the NYSE and the industry.

7/ "The October 1987 Market Break," A Report by the Division of Market Regulation of the U.S. Securities and Exchange Commission at 5-5 (Feb. 1988) ("SEC Market Break Study"). Moreover, of the approximately 6,700 upstairs firms, only about 60 were below the capital requirements prescribed by the SEC at any time during the Market Break and, of that number, only three carried customer accounts and only one of those had to be liquidated under the Securities Investor Protection Act. Id. at 5-7 to 5-8. See also SEC Recommendations Regarding the October 1987 Market Break at 25 (Feb. 3, 1988).

8/ SEC Market Break Study at 5-13.

9/ Katzenbach, "An Overview of Program Trading and Its Impact on Current Market Practices" at 18 (Dec. 21, 1987).

proprietary trading, market making and underwriting activities that they could not continue doing business; (2) the possibility that major customers of broker-dealers would default on margin loans as the result of the steep decline in the equity markets and thereby harm the financial positions of their brokers; and (3) the risk that banks might curtail existing lines of credit to broker-dealers in light of the large potential losses suffered by broker-dealers and their clients.[10/] The SEC's study made no mention of investor concerns about the activities of the independent affiliates of broker-dealer firms.

The SEC has taken the position that, "even if [a] broker-dealer's solvency is not threatened" by the activities of an affiliate, "the market may [erroneously] believe it to be threatened and treat it accordingly."[11/] This could affect the broker-dealer's own proprietary activities, it asserts, even if its customers were adequately protected.[12/] This is not, however, an appropriate basis for legislation of the type requested here. The federal securities laws are intended to protect investors, not broker-dealer firms. Moreover, the possibility that firms might be harmed by erroneous market reactions is entirely speculative. There is no evidence that such market reactions have been a problem for firms. In short, there is no concrete evidence of any need to grant the SEC jurisdiction over an entire holding company system merely because a broker-dealer is present somewhere in the system.

The Committee has also been told that the SEC is the only securities regulator in any modern country that does not have access to the information contemplated by the bill. While we have not made an exhaustive search, we have reason to question this assertion. The bill would give the SEC authority to require regular reports concerning operational and financial details of companies that have no nexus to the securities markets and no dealings whatsoever with broker-dealer firms (so long as they are in the same holding company system as a broker-dealer firm and their operations and finances are in some unspecified way "material" to the broker-dealer). The laws in the two other major financial markets do not go this far. It is our

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10/ SEC Market Break Study at 5-1 to 5-29.

11/ "Securities Market Issues For 1989: Market Liquidity, large Trader Information, and Holding company Risk Assessment," Remarks of David S. Ruder Before the Women's Economic Round Table, New York City, N.Y., May 19, 1989, at p. 21.

12/ *Id*. at 21 n.24.

understanding that there is no law or regulation in Japan that requires broker-dealers to report information about the financial and operational condition of non-broker-dealer affiliates with whom they have no dealings. The Ministry of Finance, the securities regulator in that country, merely requires Japanese broker-dealers to report on transactions with non-broker-dealer affiliates. Similarly, there is no law in the U.K. requiring broker-dealers to file reports like those contemplated by the bill. The securities regulators in the U.K. only require broker-dealers to include some very general information about affiliates in initial applications to become licensed and follow-up notices,[13] and periodically to report limited information concerning transactions with their affiliates (*e.g.*, loans to, guarantees of loans to, and receivables from affiliates).[14]

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[13] The Securities and Investments Board ("SIB"), the central U.K. regulator, and The Securities Association ("TSA"), the self-regulatory organization that regulates broker-dealers, are authorized to take into consideration any matter relating to any affiliate of a broker-dealer when they are considering an initial application for registration. *See generally* Butterworths, *Financial Services Law and Practice*, Vol. I, at I-201 to I-203 (1989). However, as indicated in the text, even in this limited context, the regulators merely require broker-dealer applicants to supply general information about their affiliates. They require applicants to submit a "'family tree'" showing their affiliates, the name and address of any holding company, information concerning any financial arrangements or written guarantees of support from affiliates, and consolidated financial statements if they are required as a matter of general accounting principles. TSA Rule Book, Chapt. II, Rule 90.01 (June 1988); Butterworths, *supra*, Vol. III, at E-1081 to E-1095. The regulators require two types of general follow-up notices regarding affiliates. They require notice when a broker-dealer acquires a subsidiary or itself becomes or ceases to be a subsidiary of another company. Butterworths, *supra*, Vol. III, at VI-103. They also require notice of the commencement of any insolvency proceeding or any proceeding to liquidate an affiliate. *Id.* at VI-102.

[14] *See generally* Butterworths, Vol. II, at D-828 to D-872, specifying the information that U.K. firms must file with securities regulators on a periodic basis.

b. The Concerns Raised by the Prospect of SEC Monitoring Jurisdiction

First Boston has serious concerns about the wisdom of granting the SEC authority to regulate broker-dealer holding company systems, quite apart from its belief that there has been no showing of need for such authority. First, it is concerned that, once the SEC obtains jurisdiction to monitor the financial and operational condition of holding company systems, the agency will inevitably attempt to use this jurisdiction to regulate the substantive business of the various non-broker-dealer companies in the systems. The power to monitor implies the power to control. Why would the SEC ask for disclosure unless it intended to take action based upon it?

The SEC has never relied on disclosure of information to ensure the financial responsibility of broker-dealers. It has never viewed disclosure in itself as adequate to protect investors from the risk that their broker-dealers may fail. The agency has instead established substantive financial responsibility standards for broker-dealers. Thus, the SEC could be expected to use its new power to regulate the risks assumed by companies in the holding company system through its control over the broker-dealer affiliate. This would create a kind of de facto, or informal, broker-dealer holding company act. If this is what the SEC seeks, we would vastly prefer that it do so directly rather than indirectly through a provision that only purports to give it monitoring authority.

Second, the requirement of holding company system reporting would place U.S. broker-dealers and U.S. markets at a competitive disadvantage in the global marketplace. U.S. broker-dealers would be at a disadvantage since their foreign competitors would not be subject to a comparable duty to disclose the operational and financial details of their holding company affiliates. As discussed previously, broker-dealers in Japan and the U.K. do not appear to be subject to similar obligations. Our markets would be at a disadvantage because there is no reason to assume that other countries would follow our lead and require detailed disclosure regarding holding company systems as the price of participation in their markets.

Third, the disclosure requirements of the bill could well discourage affiliations by broker-dealers that would add to their stability during future market breaks (should they occur). During the October 1987 Market Break, the parents and affiliates of broker-dealers served as a source of liquidity, not a drain on it. The SEC's report on the Market Break notes that, "[d]uring the month of October, several large firms responded to their equity losses and the volatile conditions by substantially increasing net capital through infusions of equity capital from parents or affiliated entities ... ."[15] While "[e]ven without the infusions all of the firms would have remained above the early warning levels at the end of October,"[16] the holding company systems provided a source of potential strength during the Market Break. This strength could be lost to some degree if the bill were passed.

Fourth, we are concerned that the bill sets virtually no limits on what types of information the SEC could require, how often it court require it, or what records the agency could require holding company systems to maintain. The bill states that the SEC could require broker-dealer holding company systems to disclose information concerning "any aspect of the financial or operational condition" of the companies in the systems that it determined had a potential material impact on broker-dealers, "including, but ... not limited to, information concerning assets, liabilities, contingent liabilities, material contracts, loan commitments, trading or investment positions, lines of credit, letters of credit, and financial guarantees." This is essentially a license to conduct a "fishing expedition" into confidential business information contained in every "pond" within the system. This would not only be intrusive but burdensome. The SEC would presumably require every holding company and affiliate to maintain books and records to ensure that the information sought is collected.[17] We believe that the Committee should think twice before granting an agency such "blank check" powers.

15/ SEC Market Break Study at 5-6.

16/ *Id.*

17/ In recommending that monitoring authority be given to the SEC, SEC Chairman Ruder effectively conceded that the agency is seeking the authority to impose recordkeeping requirements on holding companies and affiliates of broker-dealers. See Testimony of SEC Chairman David S. Ruder before the Sen. Comm. on Banking, Housing, and Urban Affairs Concerning the Working Group on Financial Markets, May 24, 1988, at 13 ("I believe that it is appropriate to adopt legislation that would authorize the Commission to establish recordkeeping and financial reporting requirements for holding companies and affiliates of registered broker-dealers ...") (emphasis supplied).

2. Large Trader Reporting

Section 3 of the bill, captioned "Large Trader Reporting," would authorize the SEC to require the filing of transaction reports by persons who purchased or sold securities in aggregate transactions that exceeded SEC-prescribed volume or value limits within 24 hour periods. The SEC has explained that these filings could be used by it "for surveillance, enforcement, and other appropriate regulatory purposes."18/ The bill would provide that the SEC is not required to disclose the information (other than at the request of Congress or pursuant to court order) but it does not require that the agency keep the information confidential.

First Boston is not opposed to efforts to ensure that the SEC has ready access to large trader transaction information when it needs such information to conduct an enforcement investigation or special study such as its study of the Market Break. The SEC clearly has had difficulty in the past in obtaining information about broker-dealer customers on a timely basis. For example, while the exchange audit trails provided the SEC with the identities of the brokers who traded on October 19 and 20, they did not provide trade data by customer. Furthermore, the records of most clearing firms did not capture order entry or execution times. Thus, the SEC was forced to engage in a manual review of individual trade tickets in order to reconstruct the events of the Market Break.

First Boston believes that the SEC's problem in obtaining information about broker-dealer customers is being solved through the cooperative efforts of the SEC and the SROs. The Intermarket Surveillance Group ("ISG"), a group of SROs which includes the NYSE, the American Stock Exchange ("AMEX"), regional exchanges, the National Association of Securities Dealers ("NASD") and the Chicago Board Options Exchange ("CBOE"), has developed an electronic "blue sheeting system." When the system is fully implemented, it will enable the SROs, and the SEC upon request, to quickly identify the names of customers and detailed data about their trades.19/ For example, it identifies the customer,

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18/ Letter from David S. Ruder to George Bush, supra, at Section-by-Section Analysis.

19/ The plan has already been adopted by the NYSE, AMEX, CBOE, and the Pacific Stock Exchange (SEC Release Nos. 34-24859, 26235, 26561, June 27, 1988 and Nov. 1, 1988, Feb. 21, 1989). The Philadelphia Stock Exchange (SEC Release No. 34-26536, Feb. 10,
(continued...)

the security traded, the trade date, the quantity traded, whether the transaction was a purchase, sale, put, or call, whether it was long or short, the price, the market center, the customer's address, his registered representative, whether the sale was solicited or unsolicited, the date the account was opened, his or her employer, and his or her taxpayer identification number.

The electronic blue sheeting system appears to provide all of the information needed to enable the SEC to conduct investigations or to prepare studies. If it does not, it could be modified or, as the NYSE has proposed in its testimony on the bill, firms could be required to collect and store the additional information in their files and disclose it to the SROs or the SEC upon request pursuant to an authorized investigation or study. First Boston concurs in the position of the NYSE that, "[t]o meet legitimate concerns about unwarranted disclosure, the data [sh]ould be compiled in member firm's file and disclosed on request ..." rather than filed directly with the SEC.

First Boston believes that the bill would merely impose yet another SEC reporting burden on investors who use our markets. It is concerned that the additional filing requirements may drive investors to other markets. This would be counterproductive. In a global marketplace that is increasingly interdependent, we cannot control volatility in our markets by driving traders abroad. Furthermore, the large trader filings might merely produce an avalanche of information that would not be used by the SEC on any consistent basis. If the intent of the bill is to deal with program trading, we believe that it would be better to regulate that conduct directly than to burden the entire marketplace with additional filing requirements.

Finally, the bill should be amended to ensure that, if information is filed with the SEC, it receives appropriate confidential treatment. The information sought by the bill would, in all likelihood, reveal trading strategies and would be very valuable to competitors. The bill would permit the SEC to treat such information as confidential but it would not require

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19/(...continued)
1989) and the NASD (SEC Release No. 34-26429, January 6, 1989) have asked for SEC approval to adopt the blue sheeting plan.

that it do so. The SEC should be affirmatively prohibited from disclosing the information except in limited circumstances in which confidentiality can be fully protected.

Sincerely,

DONALD W. RIEGLE, JR., MICHIGAN, CHAIRMAN

ALAN CRANSTON, CALIFORNIA
PAUL S. SARBANES, MARYLAND
CHRISTOPHER J. DODD, CONNECTICUT
ALAN J. DIXON, ILLINOIS
JIM SASSER, TENNESSEE
TERRY SANFORD, NORTH CAROLINA
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RICHARD H. BRYAN, NEVADA

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ALFONSE M. D'AMATO, NEW YORK
PHIL GRAMM, TEXAS
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CONNIE MACK, FLORIDA
WILLIAM V. ROTH, JR., DELAWARE
NANCY LANDON KASSEBAUM, KANSAS
LARRY PRESSLER, SOUTH DAKOTA

KEVIN C. GOTTLIEB, STAFF DIRECTOR
LAMAR SMITH, REPUBLICAN STAFF DIRECTOR AND ECONOMIST

United States Senate

COMMITTEE ON BANKING, HOUSING, AND
URBAN AFFAIRS

WASHINGTON, DC 20510-6075

July 17, 1989

The Honorable David S. Ruder
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D. C. 20549

Dear Chairman Ruder:

I am enclosing for your review and response a very thorough critique of certain provisions of S. 648, the Market Reform Act of 1989. The paper was prepared by The First Boston Corporation, which raises concerns about provisions of the bill giving the Commission authority to require reports of large trades and to require information about the condition of unregulated affiliates of broker-dealers.

Let me confirm an earlier request made by the staff of the Securities Subcommittee that the Commission, or the Commission's Division of Market Regulation, respond to these comments at the earliest possible date. As a first step, a memorandum from the Commission's staff addressing each of the points raised would help us considerably in advancing the debate on the bill.

I look forward to your reply by no later than July 28, 1989. Thank you for your continuing efforts in the area of market reform.

Sincerely,

Christopher J. Dodd
Chairman
Subcommittee on Securities

Enclosure

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE CHAIRMAN

September 7, 1989

The Honorable Christopher J. Dodd
Chairman, Securities Subcommittee
Senate Committee on Banking,
  Housing, and Urban Affairs
SD-534 Dirksen Senate
  Office Bldg.
Washington, D.C. 20510

Dear Chairman Dodd:

This letter and its attachment respond to your letter of July 17, 1989, requesting that the Commission or the Division of Market Regulation ("Division") respond to comments contained in a letter from The First Boston Corporation 1/ concerning certain provisions of the market reform bill (S. 648, The Market Reform Act of 1989).

As you know, S. 648 is based on the legislative package submitted by the Commission to the 100th Congress in June 1988. This legislative package contained four separate proposals relating to: (1) emergency powers for the Commission, (2) clearance and settlement, (3) large trader reporting, and (4) risk assessment for financial holding companies. S. 648 contains these four proposals in essentially the form originally submitted by the Commission. 2/

The attached memorandum from the Division addresses the concerns raised in the First Boston letter regarding Section 3

1/ Letter from Michael Raoul-Duval, Managing Director, The First Boston Corporation, to Senator Christopher Dodd, dated July 6, 1989.

2/ On May 17, 1989, the Commission submitted to Congress redrafted statutory language and legislative history for the large trader reporting and risk assessment provisions of S. 648. The submission incorporated technical comments received by the Commission from the other members of the Presidential Working Group and from representatives of the Securities Industry Association.

of S. 648, which would authorize the development of a large trader reporting system for the securities markets, and Section 4, which would facilitate information collection by the Commission for risk assessments for holding company systems. 3/

If I or the Division staff can provide you with any further information, please do not hesitate to call.

Sincerely,

David S Ruder

David S. Ruder
Chairman

Enclosure

Memorandum to David S. Ruder, Chairman, Securities and Exchange Commission, from Richard G. Ketchum, Director, Division of Market Regulation.

3/ The Division's memorandum does not discuss the two sections of S. 648 that were not addressed by First Boston.

MEMORANDUM

September 6, 1989

TO: Chairman Ruder

FROM: Richard G. Ketchum, Director
Division of Market Regulation ("Division")

RE: Information request from Senator Dodd concerning legislative proposals for large trader reporting and risk assessment for financial holding company systems.

By letter, dated July 17, 1989, Senator Christopher J. Dodd, Chairman of the Securities Subcommittee of the Committee on Banking, Housing, and Urban Affairs, requested that the Commission respond to comments contained in a letter from the First Boston Corporation ("FBC Letter") concerning certain provisions of the market reform bill (S. 648, The Market Reform Act of 1989). 1/ Specifically, the FBC Letter questioned the need for, and current drafting of, provisions in S. 648 concerning large trader reporting and risk assessment for financial holding company systems.

S. 648 is based on the legislative package submitted by the Commission to the 100th Congress in June 1988. The Commission's 1988 legislative package contained four separate proposals relating to: (1) emergency powers for the SEC, (2) clearance and settlement, (3) large trader reporting, and (4) risk assessment for financial holding companies. S. 648 contains these four proposals in essentially the form originally submitted by the Commission.

This Memorandum addresses the concerns raised in the FBC Letter regarding Section 3 of S. 648, which authorizes the development of a large trader reporting system for the securities markets, and Section 4, which facilitates information collection by the Commission for risk assessments of holding company systems. 2/

1/ Letter from Michael Raoul-Duval, Managing Director, The First Boston Corporation, to Senator Christopher Dodd, dated July 6, 1989.

2/ Two provisions were not addressed by the FBC Letter. First, Section 2 of S. 648 grants the Commission the authority to suspend summarily all trading on any securities exchange or otherwise for up to 24 hours during (continued...)

I. Large Trader Reporting System

A. The Need for a Securities Reporting System

Section 3 of S. 648 is designed to assist the Commission in its surveillance of the U.S. securities markets by expanding the Commission's authority to adopt reporting rules for the purpose of monitoring the impact on the securities markets of large transactions in publicly traded securities involving substantial volume or a large fair market value or exercise value, in the case of options. In particular, the Commission would be authorized to adopt rules requiring any person effecting large transactions for its own account, or for an account for which it exercises investment discretion, to file reports with the Commission or with a self-regulatory organization ("SRO") designated by the Commission. The Commission and the SROs could use the information contained in these reports for surveillance, enforcement and other appropriate regulatory purposes.

2/(...continued)
a market emergency. This provision would grant the Commission the same type of statutory authority that currently is provided to the Commodity Futures Trading Commission ("CFTC") for oversight of the commodities markets.

Second, Section 5 of S. 648, as it concerns clearance and settlement issues, would make changes both to the Securities Exchange Act of 1934 and to the Commodity Exchange Act. The pending legislation would add a finding to each of those statutes that the clearance and settlement systems for transactions in securities, options, futures, futures options, and commodity options are integrally related, and that the absence of links or coordination among those systems may impose unnecessary costs and liquidity demands on the nation's financial systems.

The legislation also would direct the Commission and the CFTC to use their authority to facilitate the establishment of linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities, options, futures, futures options, and commodity options, and to consult with each other in carrying out these responsibilities. The Commission, CFTC, and the Board of Governors of the Federal Reserve System ("FRB") would be directed to report to Congress within two years on the progress toward establishing linked, coordinated, or centralized facilities for clearance and settlement.

For many years, regulators in the U.S. commodities markets have been able to utilize large trader reporting systems to monitor market activities and to reconstruct trading for market studies or specific investigations into possible illegal activities. The usefulness of these reporting systems for reconstructions by the CFTC of trading in October 1987 was acknowledged not only in the Commission staff report on the market break, 3/ but by the report of the Presidential Task Force on Market Mechanisms ("Brady Commission"). 4/

The availability of large trader reports for futures on stock indices has been critical to the effective monitoring of the stock, options and futures markets by the Commission and CFTC. These large trader reports have proved particularly useful to the Commission and CFTC in connection with the joint monitoring efforts which are conducted for expiration Fridays. The process of information sharing and analysis enables regulators to anticipate possible market stress points and, if necessary, adjust opening or closing procedures to facilitate an orderly functioning of the market on expiration Fridays. The CFTC and the commodities exchanges regularly share information regarding large trader reports as part of this process, but neither the securities exchanges nor the Commission has such information regarding stock transactions.

Large trader reports in the securities area would enhance substantially the surveillance capabilities of both the securities SROs and the Commission. As explained in detail below, large trader reports would allow the SROs to develop more sensitive and sophisticated computer surveillance programs, which would substantially improve their ability to detect manipulative and other abusive trading activities.

3/ See Division of Market Regulation, Report on the October 1987 Market Break (February 1988), at 3-27.

4/ Regarding the adequacy of information systems, the Brady Commission concluded that intermarket information systems are currently insufficient to monitor the intermarket trading strategies that are so significant to the one-market system. Intermarket monitoring systems are necessary to assess market conditions and to diagnose developing problems.

The October experience illustrates the need for a trading information system incorporating the trade, time of the trade and the name of the ultimate customer in every major market segment. Report Of The Presidential Task Force On Market Mechanisms (January 1988), at 67.

Given the usefulness of large trader reporting systems for surveillance and investigatory programs, as well as for periodic market studies, the Commission's June 1988 legislative proposals included a request for authorization to establish a similar system in the securities markets. Section 3 of S. 648 provides this authorization substantially in the form requested in the Commission's June 1988 package.

B. Recent Proposals to Modify Section 3 of S. 648

In September and October 1988, the Commission staff received comments from the staff of the CFTC concerning the proposed securities large trader reporting system. In addition, comments on this provision were received from representatives of the Securities Industry Association ("SIA"). In response to these comments, the Commission submitted to the Congress on May 17, 1989 proposed revisions to Section 3 of S. 648 and its accompanying draft legislative history. 5/ The May 1989 revisions concerned the following areas.

First, references to collection by the Commission of information on transactions involving stock index futures or options on such futures have been deleted. This change should eliminate concerns about duplicate reporting to the Commission and the CFTC.

Second, the legislative history has been revised to provide that the Commission will consider the adequacy of SRO

5/ See letter from David S. Ruder, Chairman, Commission, to Senator Christopher J. Dodd, Chairman, Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs, dated May 17, 1989. Similar recommendations were made concerning the companion market reform bill in the House of Representatives, H.R. 1609. See letter from David S. Ruder, Chairman, Commission, to Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance, House Commerce Committee, dated May 17, 1989. These recommendations also were transmitted simultaneously to other members of the Presidential Working Group on Financial Markets ("Working Group"). The Department of the Treasury, a member of the Working Group, commented favorably on the general approach taken by the provisions of S. 648, relating to the implementation of a large trader reporting system. See letter from Robert R. Glauber, Undersecretary, U.S. Department of the Treasury, to Senator John Heinz, dated May 17, 1989 ("Glauber Letter").

reporting requirements, among other factors, in determining whether to implement a large trader reporting system. 6/

Third, the legislative history emphasizes that parameters must be set for reporting securities and filing large trader reports and that aggregation of accounts among different broker-dealers generally would occur at the SRO level or at the Commission.

Fourth, the revised legislative history indicates that, in adopting rules pursuant to Section 3, the Commission will take into account whether other means of obtaining the information are available and that every effort will be made to minimize the economic burdens of reporting and to utilize existing data streams whenever possible. The legislative history further provides that the costs and benefits of beneficial ownership reporting will be carefully considered and that the Commission will not impose requirements on broker-dealers to report beneficial ownership information that is not presently available to them. In addition, with respect to foreign persons or accounts, the new reporting requirement will not be used to supersede terms of negotiated memoranda of understanding with foreign governments.

Fifth, provisions that exempt the Commission from disclosing reported information pursuant to the Freedom of Information Act or any other law were extended to other federal departments or agencies that obtained the reported information from the Commission.

Finally, the Commission recommended that the following language be inserted into the draft legislative history for Section 3 of S. 648 to clarify that any rule-making for the large trader reporting system should take into account the effect on the U.S. capital formation process and the competitive position of the U.S. markets:

> The Commission in adopting any direct reporting rule or rules will carefully consider the total impact of the rule or rules on capital formations in the United States, and the relationship between our domestic markets and the international market place for securities. The free flow of capital has been a long-standing national policy, and

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6/ At the time that the market reform legislation was sent to Congress in 1988, the New York Stock Exchange ("NYSE") had announced its intention to develop its own large trader reporting system. Since that time, however, the NYSE has determined not to proceed with this proposal.

should not be impeded by rules or regulations adopted under this section.

C. Concerns Raised in the FBC Letter

Because of the proven usefulness of large trader reporting systems in the U.S. commodities markets and the widely acknowledged need for similar systems in the U.S. securities markets, the Commission worked with the CFTC and SIA to narrow and thus to gain wider acceptability of the provisions in Section 3 of S. 648. Nevertheless, the First Boston Corporation continues to have reservations. These concerns fall into three principal categories.

1. Need for Routine Submission of Information

The FBC Letter suggests that the routine filing of reports on trading with either the Commission or the SROs is unnecessary for the regulatory uses currently envisioned for this information. The letter suggests that it would be sufficient to require broker-dealers to maintain such information internally, to be supplied to the Commission only upon request. 7/

It is true that the Commission already has sufficient authority to require broker-dealers to maintain information with respect to transactions in securities and to provide it to

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7/ When the NYSE withdrew its proposal for a separate reporting system, Exchange officials expressed sympathy with, and ultimately agreed with, members' objections that the large trader information should not be filed routinely, but submitted only upon request by a regulator. See letter from James E. Buck, Senior Vice President and Secretary, NYSE, to Jonathan G. Katz, Secretary, Commission, dated June 12, 1989. See also Remarks Submitted for the Record by John J. Phelan, Jr., Chairman and Chief Executive Officer, NYSE, to the Securities Subcommittee of the Senate Committee on Banking, Housing, and Urban Affairs (May 18, 1989), at 14-15. Similar sentiments were expressed by the National Association of Securities Dealers ("NASD"). See Testimony of Joseph R. Hardiman, President, NASD, before the Subcommittee on Securities of the Committee on Banking, Housing, and Urban Affairs, United States Senate (May 18, 1989)("Hardiman Testimony"), at 5-6. Although acceding to member concerns in this area, the NYSE and the NASD did not address the need for large trader information to enhance market monitoring and surveillance capabilities. As discussed below, only routine filing of information would meet this need.

the Commission on an as-needed basis for both market studies and enforcement investigations. However, obtaining this information on an as-needed basis is not adequate for market monitoring and surveillance purposes. For these purposes, the routine filing provision of Section 3 is necessary.

An SRO surveillance system employs computer analysis and sets parameters to "kick out" suspicious trading activity. With the development in recent years of complete and functioning audit trails, the surveillance systems of the various markets (operating individually or collectively through the operation of the Intermarket Surveillance Group) have become quite sophisticated at detecting suspicious trading which might be violative of the rules of the SROs or of the anti-fraud provisions of the federal securities laws.

As powerful a tool as the audit trails have become for improving market surveillance techniques and for creating a complete, sequenced reconstruction of market trading, the effectiveness of these systems is still limited, however, because the data currently collected identify only the brokerage firm involved in each particular trade, not the customer or account for which the trade is effected. As a result, most investigations which result from surveillance "kick outs" involve a two-step process.

First, the surveillance systems of the SROs identify suspicious transactions (or series of transactions) or identify particular broker-dealers whose trading should be looked at--either because of the size of their trading activity or because they have some relationship to the particular stock involved. Once particular brokerage firms have been identified for inquiry, the regulators must then go to the firms and request that they provide detailed information regarding individual trades or regarding all trades in a particular security on a given day--including the names, addresses and account numbers associated with each trade for which information is requested. The process of requesting this detailed information is called "blue sheeting," from the blue color of the questionnaire forms which are sent to the brokerage firms by the various SROs or the Commission.

Two points about the blue-sheeting process are worth noting. First, the blue sheet process takes time. Normally, because of the number of blue-sheet requests which are made in the normal course of market surveillance, the time it takes firms to retrieve information from their own computer systems, and the need to afford firms the opportunity to review any blue sheet data themselves before the data are submitted to a regulator, blue sheet requests are made with a return date of ten business days.

It is true that significant advances have been made in the "blue sheet" collection process through the development, in conjunction with the NYSE and the SIA, of "electronic blue sheets" ("EBS"), whereby blue-sheet information is transmitted electronically in a standardized format to the SROs and the Commission. However, the principal benefit of EBS is at the receiving end--the SROs and the Commission no longer have to take trading data from paper filings and input that information into computer systems for analysis (a process that often took weeks for large amounts of trading information). The EBS process has not resulted in immediate access by the regulators to the type of detailed customer information necessary to complete a surveillance investigation.

Of perhaps more importance, without large trader information, the surveillance systems cannot sift through trading data in as efficient a manner as possible to avoid unnecessary blue sheet requests and lose time looking at "kick outs" which turn out to be false leads. For example, the audit trail information for a particular trading date may show that Firm A was a significant factor in the market for a particular stock on a particular day. Because the audit trail data do not show customer information, the surveillance staff does not know whether that activity represented, for example, proprietary trading by the firm's arbitrage desk, institutional trading by pension accounts or mutual funds, or agency orders entered by retail customers of the firm. This is particularly troublesome for a major retail firm such as Merrill Lynch or Shearson Lehman Hutton, where trading in a particular security could reflect a single customer or diverse activity from hundreds of separate branch offices. The nature of the trading is critical to the conduct of the surveillance investigation; however, because the customer information is not available through the audit trail, a blue sheet request would normally be made to the firm to find out why the firm is such a large factor in the market for the stock in question. The absence of large trader information, therefore, forces SROs to set surveillance parameters wider in order to avoid an unmanageable number of "kick outs."

If a system of large trader reporting were implemented, the Division believes that the surveillance systems could act as a much better screen to focus staff attention on suspicious trading activity. With large trader information available as part of the normal audit trail, the staffs of the SROs would be in a much better position to analyze trading on a current basis and could likely conduct their surveillance investigations with fewer blue sheet requests from the member firm community.

In addition to the critical need for large trader information in the market surveillance process, the availability of such information would significantly improve the staff's ability to reconstruct trading for analytical purposes. The Division's study of the October 1987 market break was substantially hampered by the absence of a large trader reporting system which could enable the staff to reconstruct trading quickly and easily. Because a large trader system was not in place, the staff was forced to go directly to the brokerage firms for trading information in an attempt to find out who were the major buyers and sellers during the critical days of October 19 and 20, 1987 so that we could analyze the trading activity and attempt to explain, to the extent feasible, the reasons for the precipitous market decline that occurred during that period.

The results of our direct inquiries were mixed at best. Some firms were not able to give us the type of information that we needed to do our market reconstruction. Some firms that did provide information were able to do so only after much delay, and the data that were supplied varied so much in format and content that it was extremely difficult for the staff to make use of the information in its analysis. Even with respect to information regarding program trading and index arbitrage, where the staff experienced the best information response from the firms involved, there was a great deal of time lost because of the need to go back to firms on many occasions because of incomplete or erroneous information.

In the time that has elapsed since the October 1987 market break, improvements have been made in collecting certain types of market information necessary to analyze the size and impact of program trading activities. The NYSE has implemented a comprehensive reporting system for program trading, and the data collected by that system, together with the monthly reports prepared by the NYSE with respect to program trading, have improved the staff's ability to review and monitor program trading activity involving the stock, options and futures markets. However, we still lack the type of information regarding the activities of large traders which would enable the staff to reconstruct trading and analyze institutional trading patterns effectively. As a result, implementation of a system of large trader reports remains a critical need for the market regulation program.

Based upon the above factors, the Division believes that the information provided by a large trader reporting system, which augments information currently available from clearing records and audit trail systems, would enhance significantly monitoring and surveillance capabilities in the securities markets. The FBC Letter, on the other hand, suggests that, instead of the regular reporting of large trader information contemplated by S. 648, firms could merely retain the large trader information in their files and the Commission and SRO staffs could access the information periodically using the EBS system. The Division believes, however, that this suggestion is conceptually flawed and unworkable.

First, if the large trader information is to be useful for surveillance purposes, it must be included as part of the basic audit trail data base. Otherwise, the surveillance staffs will not have any better idea than they do today whether a particular firm's trading activity which shows up after applying the surveillance parameters is activity which can be explained as normal institutional or retail trading or is activity which raises surveillance concerns and which would result in a blue-sheet request for further data. The point of large trader reporting is to fine tune the surveillance process and make it more efficient and effective; the FBC proposal merely describes the status quo and would not improve the surveillance capabilities of the markets in any respect.

Second, the Division believes that certain analyses for which large trader information would be necessary are ill-suited to the existing blue sheet process. The existing EBS process is currently used only for specific enforcement or surveillance investigations, which normally involve a particular security and only a few, carefully selected firms. The blue sheet process has never been used to attempt to reconstruct trading in a large number of securities involving a large number of firms, nor are we sure it would be capable of handling the amount of data which would be involved in a broad inquiry regarding market reconstruction.

For example, if the suggestion in the FBC letter were to be implemented, in order to analyze major market movements the Commission or the SROs would have to blue-sheet every major clearing firm on a daily basis in most, if not all, of the stocks comprising the major market indices. The volume of blue-sheet requests which would be necessary and the amount of data which would be sent in through the EBS system, would be far in excess of the current level of blue-sheet information traffic, and in our view would be far more burdensome to the member firms than a carefully crafted large trader reporting scheme developed by the Commission and the SROs in close consultation with the securities industry.

Finally, and of perhaps greatest importance, the FBC proposal would not address one of the most important issues which must be addressed in connection with any large trader reporting scheme--aggregation of accounts held at various brokerage firms. A brokerage firm has in its records information relating only to its own customers. If a customer has accounts at several brokerage firms, each of the individual firms may have no knowledge of the existence of the other accounts. As a result, if the reporting level (or, if the FBC suggestion were to be adopted, the recordkeeping level) for a particular stock were 100,000 shares, and Customer A effected trades in 200,000 shares of that stock through three brokers but only 50,000 shares through Broker A, Broker A would assume (based on information in its own records) that Customer A's transactions would not have to be reported (or recorded). As a result, a significant percentage of Customer A's trading would escape detection by the regulators.

The Commission proposal would address this problem in two ways. First, the reporting obligation under the proposal would be on the customer, not the broker. Only the customer is in a position to know whether the amount of trading effected on a particular day, in the aggregate, meets the reporting levels. 8/ Second, once a customer has been identified as a large trader, the SROs would be able to aggregate that customer's positions from the reporting received from the relevant broker-dealers.

While the statutory amendments do not provide explicitly for aggregation, the Commission proposal anticipates the need to address the aggregation issue by indicating, in the legislative history accompanying the proposal, that

> [t]he Commission would . . . be authorized to adopt rules prescribing the manner in which transactions and accounts would be aggregated for purposes of this section [of the legislation]. Generally, aggregation of accounts among different broker-dealers could occur at the self-regulator level or at the Commission.

The second sentence in the quoted material was added to the legislative history in the Commission's suggested changes transmitted in May 1989 and reflects discussions with the staff of the SIA on this critical issue.

2. Confidentiality Concerns

The FBC Letter suggests that Section 3 of S. 648 should be amended to contain explicit prohibitions against the release of non-public information by Commission staff. The Commission's regulations already prohibit staff from releasing any non-public information, such as the information collected under the proposed large trader reporting system, without the

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8/ The Division believes it is inappropriate, in the example discussed above, to hold a brokerage firm liable under the Exchange Act for underreporting of customer activity when the broker had no knowledge of trading conducted through another firm.

Commission's authorization. In practice, the Commission has an excellent record of maintaining the confidentiality of information collected for surveillance and investigations. In addition, the Freedom of Information Act ("FOIA") exemption proposed by Section 3 gives the Commission sufficient authority to prevent the forced disclosure of information provided to the Commission and SROs, while permitting the Commission to authorize sharing of information with Congress and, when appropriate, federal courts or other regulatory agencies. Accordingly, further amendments to Section 3 to require confidentiality appear unnecessary. However, if such amendments would alleviate continuing concerns over confidentiality, the Division would recommend that the Commission not object to their adoption, so long as legitimate information sharing among regulators would not be impaired.

3. Competitive Concerns

Finally, the FBC Letter suggests that routine collection of large trader reports in the U.S. securities markets might somehow drive investors to foreign securities markets. This suggestion, however, is not supported and ignores the experience of the commodities markets. Large trader reporting systems have a long history in the U.S. commodities markets, yet there is no evidence that these systems have "driven" investors to competing foreign markets. There is no support for the speculation that the U.S. securities markets would be undermined by a similar reporting system. Indeed, the opposite conclusion is the more likely one. Investors will utilize the markets they perceive to be more honest and less susceptible to manipulation. Finally, as discussed above, the proposed revised legislative history for Section 3 emphasizes that implementing rule-making by the Commission will take into account international competitive concerns.

II. Risk Assessment for Holding Company Systems

A. The Need for Risk Assessment for Holding Company Systems

S. 648 would give the SEC statutory authority to require a broker or dealer registered with the Commission to make such reports as the Commission prescribes concerning any aspect of the financial or operational condition of associated persons that the Commission determines is reasonably likely to have a material impact on the financial or operational condition of such registered broker or dealer. 9/ The Commission needs this

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9/ The term "associated person" encompasses holding companies that own broker-dealers and affiliates and subsidiaries of broker-dealers.

authority to monitor the activities of unregulated investment-related affiliates and holding companies on a consolidated, world-wide basis so that it may adequately determine the potential exposure to regulated broker-dealers of adverse occurrences or circumstances affecting the broker-dealers' related entities. This information is of critical importance at moments of market uncertainty, such as October 1987.

In the past decade, the unprecedented growth and change in the financial markets (including, among other things, the increased internationalization of securities markets and the growing tendency of firms to take proprietary risk positions in dealing with their customers) has resulted in the need for broker-dealers to accumulate large capital bases. To obtain the levels of capital necessary to compete on a global basis, even the largest firms have had to access the public equity markets, increase their leverage, or merge or affiliate with other entities. Many firms have created holding company structures to facilitate their world-wide growth. 10/ In this regard, the absence of regulatory accountability for broker-dealer affiliates and holding companies has enabled registered firms to move many potentially risky activities, such as interest rate swaps, bridge loans and foreign currency transactions, out of broker-dealers to unregulated entities. 11/ These activities would entail significant capital charges if conducted in the broker-dealer, and the Commission should be in a position to know the extent of the risks involved.

10/ Many major international securities firms are organized as holding companies which own all of the stock of related entities conducting business in specific securities markets worldwide. The growth of the securities business of U.S. securities firms in Europe and the Far East has increased steadily in recent times. For example, one large U.S. firm, a New York-based holding company with offices in the United States, Canada, England, and Japan, increased its revenues from overseas operations as a percentage of total revenues from approximately 5.3% in 1983 to 12.3% in 1985.

11/ The staff, pursuant to conversations with investment banking house representatives and financial experts, has determined that some of the affiliated entities of the largest investment banking houses have outstanding, at any point in time, $50 billion to $100 billion in interest rate swap transactions (notional amount) and $15 billion in foreign currency transactions. In addition, the staff estimates that the holding companies of the ten largest houses have outstanding, at any point in time, a total of $6 to $8 billion in bridge loans.

The expansion of firms' activities domestically and abroad, the change in their capital structures, and the transacting of significant portions of their total investment-related activities outside of the broker-dealer, including potentially risky proprietary business, have made it increasingly difficult for the Commission to evaluate the operations and financial stability of securities firms without a thorough understanding of the overall corporate structures to which they belong. For example, in order to better assess the financial condition of broker-dealers, information concerning the bridge financing activities of holding companies of investment banking firms would be valuable. In a bridge financing transaction, the holding company commits its own capital, often for an acquisition-related or leveraged buy-out transaction of certain clients. In connection with the financing, the affiliated broker-dealer usually underwrites debt instruments of the client. The proceeds of that underwriting are generally used to satisfy the obligation of the broker-dealer's client under the bridge financing. Until the proceeds are collected, the broker-dealer's holding company is exposed to the risk that the broker-dealer's client may default on its bridge financing obligation. Moreover, in the case of a holding company structure where the majority of assets and capital are in the registered broker-dealer, creditors may be relying on the credit standing of the broker-dealer, as well as the holding company, to support the bridge financing. 12/

During the October 1987 market decline, the ability of broker-dealers to market debt instruments, the proceeds of which were intended to satisfy the bridge loan obligations of the issuers, was temporarily reduced. The events of the market break demonstrate the potential exposure from unregulated financing activity.

Traditionally, U.S. securities laws have sought to insulate broker-dealers and their customers from financial failures in the broker-dealers' affiliated entities. Specifically, the Commission's financial responsibility rules require that substantial capital sufficient to meet reasonably anticipated business and trading losses remain in the broker-dealer at all times. Moreover, the Commission's customer protection rule ensures that customers' fully-paid and excess margin securities are segregated and imposes strict controls on the use of other customer funds and securities. While this regulatory structure remains sound, it does not fully protect

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12/ The staff has determined that in some cases the amount of the bridge loan, and, therefore, money at risk, has exceeded the broker-dealer's excess net capital.

the broker-dealer from the impact of financial failures of affiliated entities. Exposure to the broker-dealer firm can result directly from the withdrawal of capital from the firm in order to meet obligations of unregulated affiliates, and indirectly from the impact on the firm's financing when it is unable to rely on the holding company for capital infusions during times of crisis.

To anticipate the exposure that may result directly from the operations or actions of affiliated entities, the Commission would, for example, require access to information which would tend to reveal the amount of equity capital in a broker-dealer that is supported by debt at the broker-dealer's unregulated holding company. To the extent the holding company is highly leveraged and runs into financial difficulty, substantial capital may be withdrawn quickly from the broker-dealer, possibly causing the broker-dealer to be more vulnerable to sharp fluctuations in the markets.

It should be emphasized that the proposal does not reflect a lack of confidence in the firewalls required by the net capital rule. Rather, the proposal reflects the notion that the net capital rule serves a fundamentally different purpose. While the net capital rule places strict limits on how much capital must remain in the broker-dealer, the removal of millions of dollars of net capital above certain prescribed levels may adversely impact the willingness of major participants in the securities markets, as well as the commercial paper market or banks, to continue extending credit to the firm. Knowledge of the financial and operational condition of the entire broker-dealer holding company complex is essential to the SEC's ability to anticipate when, or understand why, banks have withdrawn credit lines or restricted lending arrangements because of a deterioration of the financial health of affiliated parties.

Moreover, financial difficulties at the holding company or affiliated entities could impact the ability of the broker-dealer subsidiary to obtain sufficient short-term financing to meet its operating and settlement obligations. Broker-dealers enter into repurchase agreements to fund much of their short-term financing or investment needs. If the holding company complex encountered financial difficulties, a creditor (or contra party) might force the broker-dealer to provide additional securities as margin. A small increase in the required margin could force the broker-dealer to liquidate the transactions and seriously affect its short-term financing ability. Accordingly, the ability of a U.S. broker-dealer to continue operations if a major affiliate ceased operations or encountered financial difficulties could be severely restricted. Furthermore, the abrupt liquidation of transactions by a large broker-dealer might seriously impact other major players in the securities markets as well as the overall functioning of the financial markets. Given these concerns, it is imperative that the Commission have access to concrete information regarding at least the other major unregulated financial operations carried out in the holding company system. With the ability to obtain this information quickly, the Commission staff would possess knowledge of the firms which are most unstable during a period of high stock market, interest rate or exchange rate volatility. Moreover, if contra party or financial institution concerns arise over the stability of other parts of the holding company, the Commission lacks the information to address these concerns adequately.

B. Recent Modifications to Section 4 of S. 648

The Commission staff have received several technical comments on the risk assessment provision of the bill from the staff of the FRB and representatives of the SIA. In response to those comments, the Commission submitted to Congress on May 17, 1989 proposed revisions to Section 4 of S. 648 and its accompanying draft legislative history. (See note 5, supra).

The following revisions were proposed. First, the section provides an exception from reporting for an entity that is subject to the jurisdiction of a regulatory authority with the "authority to collect" from the entity information similar to that required under Section 4 of S. 648. Second, the reference in Section 4 of S. 648 is revised to include bank holding company subsidiaries (other than registered brokers or dealers). Third, the legislative history clarifies that the reference to "banks" in this context includes "foreign banks." Fourth, the FOIA exemption in the revised version was expanded to cover other federal departments or agencies that obtained the information from the Commission. Lastly, in order to facilitate the Commission's ability to develop agreements with foreign regulators concerning information sharing in the area of capital adequacy and financial supervision, the FOIA exemption has also been expanded to include any similar information received by the Commission from any domestic or foreign regulatory agency.

C. Concerns Raised in the FBC Letter

In addition to questioning the need for the authority granted to the Commission by Section 4 of S. 648, the FBC letter raises several other concerns. These concerns fall into three categories.

1. Concerns about possible abuse of Commission power to monitor the financial and operational condition of holding companies

In its letter, FBC states that once the Commission is granted jurisdiction to monitor the financial and operational condition of holding company systems, it inevitably would attempt to use this authority to regulate the substantive business of the various non-broker-dealer affiliates.

Section 4 of S. 648 would require broker-dealer related entities only to make reports that are reasonably likely to affect the financial or operational condition of the broker-dealer. The language of Section 4 contains no provision conferring power on the Commission to regulate broker-dealer holding company systems' operations.

The Commission needs the authority which could be granted by Congress to gather information concerning the financial or operational condition of entities in the holding company system that could materially impact a broker-dealer. The Commission does not desire to regulate the activities of nor the risks assumed by a holding company system of which the broker-dealer is a part. Rather, the purpose of the risk assessment section of S. 648 is to enable the Commission to monitor effectively affiliate and holding company activities so that it may obtain early warning of any problems in these entities that would threaten the financial well-being of registered broker-dealers. The SEC would thus be in a better position to consult with SROs and domestic and foreign government agencies in order to plan possible responsive action and avoid further endangering the financial integrity of the securities industry.

The history of the Commission's use of similar jurisdictional authority shows no abuse of this grant of authority from Congress. The Commission has always possessed broad rulemaking authority under Section 17(a) of the Securities Exchange Act of 1934 to require such recordkeeping by registered broker-dealers as the Commission by rule prescribes as necessary or appropriate in the public interest, for the protection of investors or otherwise in furtherance of the purposes of the Securities Exchange Act of 1934. The Commission has never used this authority to regulate the financial and operational activities of a broker-dealer. Despite our difficulty in seeing how the words of the grant of authority could be construed to empower the Commission to regulate holding company systems, as FBC suggests the Commission inevitably would do, we would have no objection to a statement in the legislative history to the effect that this section gives the Commission no authority to regulate the activities of the holding company system.

2. Competitive Concerns

The FBC letter suggests "the requirement of holding company system reporting would place U.S. broker-dealers and U.S. markets at a competitive disadvantage in the global marketplace. U.S. broker-dealers would be at a disadvantage since their foreign competitors would not be subject to a comparable duty to disclose the operational and financial details of their holding company affiliates. . . . Our markets would be at a disadvantage because there is no reason to assume that other countries would follow our lead and require detailed disclosure regarding holding company systems as the price of participation in their markets." In addition, FBC asserts in its letter that Section 4 of S. 648 would discourage affiliations by broker-dealers that would add to their financial stability during future market breaks.

The Division believes that FBC's assertion that regulatory authorities in other countries generally do not possess the authority to require disclosure of holding company activities is factually incorrect. The only other country with a major securities market in which banking and securities businesses are separated as in this country is Japan. All other countries in the world with major securities markets can be categorized as markets where securities business (i.e., proprietary trading, new issue underwriting, secondary market making and agency transactions on behalf of customers) is regarded as banking business (universal banking countries such as the Federal Republic of Germany) or most of the significantly sized securities companies are owned by banks or banks are permitted to carry on securities business themselves [e.g., the United Kingdom ("U.K.")]. As such, the regulatory schemes in these countries generally employ consolidated supervision where regulators have access to information regarding holding companies which the Commission does not.

Because the U. K.'s system of regulating banking and securities businesses is different from the U.S. system, it is difficult to compare the two systems. However, the regulatory framework and recent initiatives of regulators and SROs in the U.K. enable U.K. authorities to obtain and exchange more information concerning the activities of affiliated entities of U.K. companies that engage in financial activities than the Commission is authorized to obtain from affiliated entities of U.S. registered broker-dealers.

One important difference between the U.S. and U.K. systems is that while firms engaging solely in interest rate swap transactions are not regulated in the U.S., firms engaging in the business of arranging and entering into interest rate swap transactions are regulated in the U.K. 13/

Additionally, an entity which desires to conduct "investment business" in the U.K. must apply under the FSA for authorization from U.K. regulators. The FSA empowers the Securities and Investments Board (the "SIB") to assess the fitness and properness of the applicant. In assessing the fitness and properness of an applicant, the SIB may take into account any matter (including the financial standing) relating to related entities. 14/ The SIB may require information from the applicant relating to its proposed investment business and any other information which may reasonably be required to determine whether to authorize the applicant, including information about the financial and operational activities of the applicant's related entities. 15/ Finally, and most importantly, under the FSA, the SIB may inquire as to the activities of entities related to an authorized institution not only during the application process, but also on an on-going basis. 16/ Generally, the SROs have authority similar to that possessed by the SIB, pursuant to SRO rules, to assess the properness and fitness of applicants.

There also has been a recent development in the U.K. which has as its objective goals quite similar to the risk assessment legislation goals. U.K. bank, insurance and financial service (including securities) supervisors meet annually, or more frequently if there is cause for serious supervisory concern, to discuss conglomerates in the U.K. which are subject to regulation by more than one regulatory body. After first identifying who regulates which entity in the conglomerate, the regulators exchange information about the different entities within a conglomerate to understand better the entire holding company complex and to promote supervisory coordination and proper coordination of supervisory action.

13/ See definition of "investments" and "investment business" under the Financial Services Act of 1986 (the "FSA"), Part I, Chapter I, Section 1; Schedule 1, Part I, Section 9; and Schedule 1, Part II, Sections 12 and 13. See also Part I, Chapter IV, Section 43 and Schedule 5 of the FSA.

14/ See Part I, Chapter III, Sections 26 and 27 of the FSA.

15/ Id.

16/ Part I, Chapter III, Section 27 of the FSA has been interpreted to be incorporated within the provision contained in Part I, Chapter III, Section 28 of the FSA, which concerns the withdrawal and suspension of authorization of an authorized institution.

The attendees of these "colleges of lead regulators" also discuss certain entities within the conglomerates that may be conducting activities which are not regulated.

The Securities Bureau of the Ministry of Finance ("MOF"), which regulates securities activities in Japan, has access to much more information concerning the operations of a securities house's related entities' operations than does the Commission. However, to compare the MOF's ability to obtain information about the operations of companies related to a Japanese securities house with the Commission's ability to obtain information about a broker-dealer's holding company system, one must first identify and recognize the differences between the two systems. One major difference between the U.S. and Japan is the ownership structure of securities companies. Japanese securities houses generally do not operate within a larger holding company structure. While a U.S. securities firm may be affected by the operations of its parent, affiliated companies and subsidiary companies, a Japanese firm would be affected mostly by the operations of its subsidiaries.

The Securities Bureau of the MOF can obtain from an entity applying for authorization as a securities house information about its parents and subsidiaries. The information would include the parent's or subsidiary's financial information, and, if necessary, other information. The Securities Bureau also can request information concerning a securities house's parents' or subsidiaries' activities on an on-going basis.

According to discussions with representatives of the MOF, certain activities that are not conducted in broker-dealers in the U.S., and therefore are not regulated, are subject to regulation in Japan. In Japan, interest rate swap transactions are conducted only by securities houses or banks. As such, these transactions are regulated by the Securities Bureau of the MOF if conducted by securities houses, or the Banking Bureau of the MOF if conducted by banks. Foreign currency transactions in Japan are conducted, for the most part, by authorized foreign exchange banks. To conduct such activities, an entity must be authorized by the International Finance Bureau of the MOF. Finally, bridge loan activities in Japan generally have been conducted by banks, which are regulated by the Banking Bureau of the MOF.

Finally, it is difficult to see how the adoption of S. 648 would harm U.S. securities firms' competitive positions or discourage broker-dealers' affiliations. Rather, it would appear that U.S. customers and broker-dealer creditors and trading partners would have a higher level of confidence in U.S. broker-dealers and the U.S. markets if the Commission possessed the ability to assess the financial stability and well-being of U.S. broker-dealers and their related entities.

3. Concerns about the scope of Section 4 of S. 648

Finally, FBC expressed its concern that the provision of Section 4 of S. 648 is overly broad and essentially a license to conduct a "fishing expedition" into confidential business information in every "pond" within the holding company complex. Since this information would remain confidential and the Commission would have the right to see information if the transaction was done in the broker-dealer, it is not exactly clear what FBC's concerns are. As stated above, the purpose of Section 4 of S. 648 is to enable the Commission to monitor effectively affiliate and holding company activities so that it may obtain early warning of any problems in these entities that would threaten the financial well-being of registered broker-dealers. The legislation is not intended to impede U.S. broker-dealers' ability to compete in the global marketplace. In order to ease the reporting burden on holding company systems, the proposal does limit the type of information the Commission may require. Holding company systems would only be required to report information that will have or is reasonably likely to have a material impact on the broker-dealer's financial or operational condition.

The original risk assessment proposal provided that no information regarding the activities of banks, savings and loan associations, bank holding companies, savings and loan holding companies, insurance companies, futures commission merchants and introducing brokers would need to be provided directly to the Commission, so long as similar information is available to a supervisory agency as defined in 12 U.S.C. 3401(6), a state insurance commission or similar state agency, or the CFTC. To further ease the reporting requirements on holding company systems, the Commission, in its proposed modifications to the legislation submitted on May 17, 1989, further narrowed the information which would have to be reported concerning broker-dealer related entities. The modifications clarified that the activities of foreign banks and subsidiaries of bank holding companies which are not registered brokers or dealers would not need to be provided directly to the Commission provided a regulatory agency has the authority to collect information similar to the information the Commission may collect under the risk assessment section.

The Commission has no desire to conduct "fishing expeditions" in every "pond" within the system. Nor is there reason to believe, as FBC suggests, that the Commission would require broker-dealers to maintain standardized books and records in this regard. Rather, the Commission desires to monitor the stability of broker-dealers and their holding companies in a manner that would be least burdensome to the parties involved.

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July 25, 1989

The Honorable Christopher J. Dodd
The Honorable John Heinz
SD-534 Dirksen Senate Office Building
Washington, DC 20510

Dear Senators Dodd and Heinz,

This Association represents over 7000 professionals in the securities industry in the United States, Canada, the United Kingdom, and Europe. We are writing on behalf of our Board of Governors to furnish selected comments on the proposed "The Market Reform Act of 1989" (S.648) as requested by the Securities and Exchange Commission ("Commission").

Our membership was extremely active in the buying, selling and positioning of securities during the market adjustment of October 19-20, 1987 and the weeks following. Immediately after this period, our members participated with representatives of the National Association of Securities Dealers, Inc. in formulating the enhancements adopted to the NASDAQ Small Order Execution System for the purpose of avoiding many of the events experienced during that market break. We share the Commission's concern in the event of a recurrence of those trading anomalies and believe that for the most part, the legislative proposals are

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Security Traders Association of Wisconsin, Inc.

designed to assist the Commission in confronting emergencies which may arise in our faster moving global markets. We do, however, hold extremely strong beliefs as to the necessity for the continuing availability of our market place to permit the general investing public to buy and sell securities. Very simply, we do not believe that it is in the best interest of our customers or our financial system to close our markets short of an extreme national emergency.

It is noteworthy that on October 19 and 20, 1987 our markets remained open, and while erratic, demonstrated their viability. The Government did nothing, and to paraphrase SEC Commissioner Joseph A. Grundfest, that was good news. A reputation is an asset that is hard-earned. We in the industry value our reputation for standing ready to handle customers' orders and in October, 1987 that reputation was totally justified in every segment of this country's securities markets. If ever there was any doubt, one only has to look at what happened in Hong Kong that same week when that Exchange was closed. Financial panic best describes what took place.

And, in this country there was apprehension when there was the slightest hint that SEC Chairman David S. Ruder had actually discussed the possible closing of the New York Stock Exchange. Thankfully, that did not happen. However, the mere ability to suspend trading completely, even if never exercised, could have a calamitous effect. If investors believed that trading could be suspended there could be a rush to close out accounts in order to avoid being frozen into a position. This type of knee-jerk or panic reaction could have a run-on-the-bank result. We also are concerned with the effect on the resumption of trading by the obvious pileup of orders during a suspension.

It is for these reasons that we can not support the Commission's requested amendments to Section 12 of the Securities Exchange Act of 1934 granting it extraordinary authority to suspend trading in all markets. The checks and balances of a Presidential override does not, in our estimation, provide a sufficient safeguard. We note that Section 12(k) already grants the Commission the authority, with the prior approval of the President, to suspend trading for up to 90 days. We believe that this is sufficient to maintain orderly markets without the added power being sought by the Commission. (Interestingly, this recommended added authority would be in addition to and not in lieu of the suspension power already contained in Section 12 of the Exchange Act.)

We hope that these comments will assist you in your consideration of the legislation. If we can furnish any other information, please let us know.

Respectfully,

Austin H George

Austin H. George
Chairman

John L Watson

John L. Watson III
President

cc: The Honorable Alan Cranston
The Honorable Jim Sasser
The Honorable Terry Sanford
The Honorable Richard C. Shelby
The Honorable Timothy E. Wirth
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JOSEPH R. HARDIMAN
PRESIDENT

September 25, 1989

Honorable Christopher J. Dodd
Chairman
Honorable John Heinz
Ranking Minority Member
Securities Subcommittee
Senate Committee on Banking,
Housing, and Urban Affairs
Washington, D.C. 20510-6075

Dear Senators Dodd and Heinz:

This letter responds to your May 31, 1989 letter requesting suggestions and comments on the SEC-proposed S. 648, the Market Reform Act of 1989. A recent meeting of the NASD Board of Governors discussed your request for suggestions on S. 648, which resulted in the comments below. Our comments are set out by each section of the bill, with the least lengthy discussed first.

Coordinated clearing (Section 5) - These provisions would require the SEC to work with the CFTC and the Federal Reserve Board (FRB) to establish linked, coordinated, or centralized facilities for clearance and settlement. The NASD testimony strongly endorsed these provisions, and the Board continues to hold this view.

Emergency authority and trading halts (Section 2) - These provisions would expand the SEC's emergency powers under the 1934 Securities Exchange Act to allow it to close markets and halt trading without first getting the approval of the President, as is now required by Section 12(k) of the 1934 Act. In our testimony, the NASD opposed these expanded powers, consistent with the NASD Board's September 20, 1988 position. It is our firm belief that the decision to close markets should rarely be exercised and then only by those closest to the markets, i.e., those self- regulatory organizations (SROs) responsible for operating the markets. The discipline should be to keep markets open for investors to achieve price discovery and liquidity, which cannot occur while markets are closed. Only in national emergencies should the markets be closed, and the President already has the authority to take such action under Section 12 of the 1934 Act. The NASD firmly believes that the SEC's current power under Section 12(k) to suspend trading for up to 90 days with the prior approval of the President is sufficient to maintain orderly markets, and the SEC's proposal to allow the Commission to make the closing determination, subject to a subsequent presidential override, does not provide a sufficient safeguard against a potentially inappropriate use of an extraordinary power.

Large trader reporting (Section 3) - These provisions are patterned after the CFTC's authority, and empower the SEC to adopt rules to require large traders to file trade reports with the SEC or the SROs. The NASD's testimony questioned the need for the change and pointed out that: 1) it would be expensive to implement, and 2) the information sought is already available to the SEC and the SROs on a request – rather than on a continuous reporting – basis using electronic blue sheets, once problem activity has been identified.

Our discussions with the SEC staff indicate that, based on their difficulty in obtaining information in a timely manner after the October 1987 market break, they are seeking access to the kind of information now available through the automated blue sheet process, but in a faster and more uniform format. There are, however, significant member concerns of a cost and confidentiality nature connected with the SEC proposal: 1) collecting all of this proprietary information on a continuing basis, without showing a specific need for it; 2) requiring significant additional -- and expensive -- amounts of information to be collected and maintained, which would only be used infrequently, and which runs counter to the Paperwork Reduction Act's goal of minimizing the Federal paperwork burden; and 3) mandating reporting by NASDAQ market makers, who by reason of their role generate a large amount of activity during the day, even though their positions may show no significant change at the end of the day.

We believe that these industry concerns can be alleviated by the suggested language in the attached marked draft (Attachment A). That draft, except for the proposed NASD changes, was sent to you on May 17, 1989 by SEC Chairman Ruder as an alternative draft of the legislation. The underlined and bracketed material indicates the changes the SEC has made to its original draft submitted to you. The additions that we offer are in **bold face type** and the deletions are ~~struck through~~. The changes would:

1) Alter the language from continuously reporting information to the SEC to a requirement for broker-dealer record keeping "readily available" in usable format (e.g., by within two business days) to the SEC upon request.

2) Clarify in the legislation itself (rather than in the legislative history, as was suggested in the SEC draft) that the SEC is to use existing data wherever possible -- information that is kept by broker-dealers in "the normal course of business".

3) Delete market makers and specialists from possible coverage when they are acting in a market making capacity, thereby providing essential liquidity to the markets.

Risk assessment for holding company systems (Section 4) - These provisions clarify the SEC's authority to require reports on associated persons of broker-dealers that could materially affect the operating condition of the broker-dealer. No reports would be required of individuals, or for banks, savings and loans, insurance companies, or futures commission merchants, if they otherwise were subject to comparable reporting. The SEC would have the authority to exempt associated persons who were diversified holding companies and international financial organizations that do not have a significant portion of their assets involved in the U.S. securities markets.

The NASD's testimony questioned (i) whether there has been a demonstrated need for this additional information, and (ii) reasons stated for the exceptions (e.g., banks, S&Ls, insurance companies) -- if it is because comparable information is reported to other regulators, then all Section 12 reporting companies should likewise be excepted. The NASD's testimony also expressed concern that this requirement may have an adverse impact on international institutions that have domestic broker-dealer affiliates.

We understand this authority is essentially similar to that held by the FRB and many foreign countries regarding financial holding companies, so they can be alert to problems before such problems take on major proportions. There continues to be a concern, however, that the SEC would again be collecting proprietary information on a continuing basis, without a particularized need for it.

We suggest that this concern can be addressed by the suggested changes in the attached marked draft (Attachment B). This draft is the same SEC draft as used in Attachment A, using the same convention to show SEC and NASD changes. The changes suggested would:

1) Require an annual risk assessment on the holding company system, to be performed by internal or external auditors, the results of which would be promptly available to the SEC on request.

2) Require filing annual reports on the holding company with the SEC.

3) Require maintaining records with the required information in the member firms, but "readily available" to the SEC or the appropriate SRO upon request.

Thank you for considering our comments. If you or your staff would like to discuss them further, please do not hesitate to call me on 728-8100 or John Komoroske on 728-8475.

Sincerely,

Joseph Hardiman
President

Attachments

Attachment A

SEC Modified Version for S.648 Sent to Senator Dodd May 17, 1989
SEC Changes - Bracketed material deleted / underlined material inserted
NASD Changes - ~~Struck material deleted~~ / bolded material inserted

SEC.3. LARGE TRADER REPORTING.

Section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m) is amended by adding at the end the following:

"(h)(1) For the purpose of monitoring the impact on the securities markets of securities transactions involving a substantial volume or a large fair market value or exercise value **other than those transactions of dealers registered as market makers on an automated inderdealer quotation system and acting in that capacity or as specialists on a national securities exchange and acting in that capacity** [and related transactions in equity index futures and options on such futures,], every person who, for his own account or an account for which he exercises investment discretion, [effects–

"(A) transactions for the purpose or sale of any publicly traded securities or options, or

"(B) transactions in contracts of sale (or options on such contracts) for future delivery of a group or index of publicly traded securities (or any interest therein or based on the value thereof) that are related to transactions in publicly traded securities or options,]

effects transactions for the purpose or sale of any publicly traded securities or options by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of a national securities exchange [or board of trade], during any 24-hour period in an amount equal to or in excess of such amount as shall be fixed from time to time by the Commission, shall ~~file reports~~ **keep records readily available in specified format** regarding such transactions with the Commission, or any self-regulatory organization as the Commission shall designate by rule, regulation, or order ~~to receive such reports~~. **Records** ~~Reports~~ required under this subsection shall ~~be filed at such times, and~~ include such information with respect to any transaction or series of transactions subject to this subsection, as the Commission by rule, regulation, or order may prescribe. **In requiring such information, the Commission shall, consistent with the need for market surveillance, minimize the economic burden of such record keeping, utilize existing data where possible, and require broker dealers to keep only such beneficial ownership information that is recorded in the normal course of business.**

"(2) For purposes of this subsection –

"(A) the term 'publicly traded securities or options' shall mean[s] any equity securities, including options on individual equity securities, and options on a group or index or such securities, listed, or admitted to unlisted trading privileges, on a national securities exchange, or quoted in an automated inter-dealer quotation system; and

"(B) two or more persons acting as a partnership, limited partnership, syndicate, or other group, for the purpose of effecting transactions described in paragraph (1) of this subsection, shall be deemed a 'person'.

(3) The Commission may prescribe rules governing the manner in which transactions and accounts shall be aggregated for the purpose of paragraph (1) of this subsection.

(4) Notwithstanding the provisions of section 552 of title 5, United States Code or of any other law, the Commission (or any other Federal department or agency) shall not be compelled to disclose any information required to be reported under this subsection [.] ;Provided, however, That [N]nothing in this subsection shall prevent the Commission from complying with a request for information from a duly authorized

committee or subcommittee of the Congress, or any other Federal department or agency requesting the information for purposes within the scope of its jurisdiction, or complying with an order of a court of the United States in an action commenced by the United States or the Commission.

"(5) The Commission by rule, regulation or order, may exempt any person or classes of persons or any transaction or classes of transactions, either conditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection, and the rules and regulations thereunder.".

Attachment B

SEC Modified Version for S.648 Sent to Senator Dodd May 17, 1989
SEC Changes - Bracketed material deleted / underlined material inserted
NASD Changes - ~~Struck material deleted~~ / **bolded material inserted**

SEC.4. RISK ASSESSMENT FOR HOLDING COMPANY SYSTEMS.

Section 17 of the Securities Exchange Act of 1934 (15 U.S.C. 78q) is amended by adding at the end the following:

"(h)(1) [For the purpose of monitoring the financial and operational condition of persons subject to this section, and to provide greater protection for investors,] [e]Every person who is (A) a registered broker or dealer, or (B) a government securities broker, government securities dealer, or municipal securities dealer for which the Commission is the appropriate regulatory agency, shall make such **annual** reports **and** ~~**an annual risk assessment**~~ **and keep such records in specified format readily available on request of the Commission or any appropriate self regulatory organization** as the Commission, by rule, regulation or order, prescribes concerning any [aspect of the financial or operational condition] transaction, agreement, contract, arrangement, or event (or any series or combination thereof) of or related to any of its associated persons, other than a natural person that the Commission determines will have or is reasonably likely to have a material impact on the financial or operational condition of such person. Reports **and records** prescribed by the Commission under this section may include, but shall not be limited to, information concerning assets, liabilities, contingent liabilities, material contracts, loan commitments, trading or investment positions, lines of credit, letters of credit, and financial guarantees.

"(2) No information shall be required of any person subject to paragraph (1) of this subsection regarding any associated person that is --

"(A) a financial institution as defined in Section 3(a)(46) of this title;

"(B) a bank holding company, as defined in section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a)) and any subsidiaries (other than a registered broker or dealer) of such a bank holding company;

"(C) a savings and loan holding company, as defined in section 408(a)(1)(D) of the National Housing Act (12 U.S.C. 1730a(a)(1)(D);

"(D) an insurance company, as defined in section 2(13) of the Securities Act of 1933 (15 U.S.C. 77b(13)); or

"(E) a futures commission merchant or introducing broker as defined in section 2 of the Commodity Exchange Act (7 U.S.C. 2);

[if information substantially similar to that required to be included in reports under paragraph (1) of this subsection is available to] so long as a supervisory agency as defined in section 1101 of the Financial Right to Privacy Act of 1978 (12 U.S.C. 3401(6)), a State insurance commission or similar State agency, or the Commodity Futures Trading Commission [.] has the authority to collect information substantially similar to that required to be included in reports under paragraph (1) of this section.

"(3) The Commission, by rule, regulation or order, may exempt any person or classes of persons, either conditionally or upon specified terms and conditions or for stated periods, from the provisions of this subsection, and the rules and regulations thereunder. In granting such exemptions, the Commission [shall] may consider, among other factors, the primary business of any associated person, the nature and extent of domestic or foreign regulation of the associated person's activities and, with respect to the person required to report pursuant to this subsection and its associated persons, on a consolidated basis, the proportion of assets devoted to, and revenues derived from, activities in the United States [financial] securities markets.

"(4) Notwithstanding the provisions of section 552 of title 5, United States Code or of any other law, the Commission (or any other Federal department or agency) shall not be compelled to disclose any information required to be reported under this subsection [.] , or any similar information relating to the financial or operational condition of any associated person of (A) a registered broker or dealer or (B) a government securities broker, government securities dealer, or municipal securities dealer for which the Commission is the appropriate regulatory agency, supplied to the Commission by any domestic or foreign regulatory agency: Provided, however, That [N]nothing in this subsection shall prevent the Commission from complying with a request for information from a duly authorized committee or subcommittee of the Congress, any other Federal department or agency requesting the information for purposes within the scope of its jurisdiction, or complying with an order of a court of the United States in an action commenced by the United States or the Commission."

S648DODD.4

FIRST BOSTON

The First Boston Corporation
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Michael Raoul-Duval
Managing Director

October 12, 1989

The Honorable Christopher J. Dodd
Chairman, Securities Subcommittee
Senate Committee on Banking,
Housing, and Urban Affairs
SD-534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Dodd:

This letter is in response to the September 7th letter from Chairman Ruder to you and the attached memorandum ("Memorandum") from Richard G. Ketchum, Director, Division of Market Regulation, responding to the points raised in our letter to you dated July 6th concerning provisions of the market reform bill (S. 648, The Market Reform Act of 1989). With regard to the subject of large trader reporting, we find the argument in the SEC's Memorandum concerning the agency's need for this information for enforcement purposes to be persuasive. Accordingly, we support this provision of your bill. However, on the subject of risk assessment for financial holding companies, we continue to strongly oppose the granting of the additional SEC power in this area that is contained in S.648. We do not believe that Commission has met the burden of presenting a reasonable rationale why it needs such authority.

The SEC's Memorandum points out that obtaining large trading information on an as-needed basis is not adequate for the purposes of their monitoring and surveilling systems, nor for the computer systems utilized by SROs, which "kick out" suspicious trading activity based on certain pre-set parameters. The SEC and the SROs have far better information concerning the utility of such computer-based systems than we do and, thus, we accept fully their assessment of the need for this information. Once it is conceded that the information is needed for effective compliance, we have no reservation whatsoever in fully supporting any reasonable activity by the SEC to obtain the data. First Boston has consistently and enthusiastically urged Congress to increase enforcement powers of the SEC in the area of compliance as one of the best means of protecting the integrity of the market. Accordingly, First Boston fully supports the SEC request

A CS First Boston Company

for the authority to develop a large-trader reporting system for the securities markets.

First Boston continues to believe that the risk assessment section of the bill is not necessary for the protection of investors. The SEC's Memorandum does not provide a convincing argument of why it is necessary to give the SEC power to require broker-dealers to routinely report information about their affiliates. As we explained in our initial letter, the SEC's own staff concluded prior to the October 1987 Market Break that the net capital rule adequately insulates broker-dealers and their customers from risks undertaken by affiliates (First Boston at 2-3). If the Market Break demonstrated anything, it showed the adequacy of the rule. The studies of the Market Break uniformly found that the rule had worked well and was not in need of any major repair (*id.* at 4). The SEC's own study of the Market Break pointed out that the net capital rule "'adequately measured[d] the actual and contingent risks for securities firms'" and provided a "'reasonable safety margin during the October market break'" (*id.*).

The SEC's Memorandum does not make any real attempt to reconcile its position on the risk assessment provision with its position on the net capital rule. It concedes that the rule "remains sound" and that the agency does not "lack confidence in the firewalls required by the net capital rule" (Memorandum at 14-15). The Memorandum then goes on, however, to make a number of general assertions that appear to be flatly inconsistent with its conclusions about and our experience with the net capital rule. It asserts, for example, that there is a risk that a highly-leveraged parent might "quickly" withdraw "substantial capital" from a broker-dealer to meet its own capital needs, thereby leaving the broker-dealer in an impaired condition (*id.* at 15). But, as we noted in our letter, the SEC's net capital rule prohibits the withdrawal of capital from a broker-dealer to aid an affiliate when it would leave the broker-dealer with capital that is below the early warning level set by the agency -- a level which *exceeds* the capital requirement that the agency has specified as *adequate* for broker-dealers (First Boston at 3). The agency's own staff previously pointed out that this prevents a broker-dealer from aiding an affiliate experiencing financial difficulty if to do so could even "'*possibly* endanger a registered broker-dealer's stability'" (*id.*, citation omitted, emphasis supplied).1/

1/ The SEC also suggests a number of other situations in which an affiliate's problem might spill over indirectly onto a broker-
(continued...)

Notwithstanding our belief that the net capital rule offers more than sufficient protection against risks taken by affiliates, we would not object to a statute that gave the SEC the specific but limited authority to request information about the activities of certain affiliates during a market "emergency" as defined in Section 2 of the bill. We would also have no objection to a provision that gave the agency the authority to obtain information when it had reasonable cause to believe, under the facts of a particular case, that the problems of an affiliate were likely to spill over onto and impair the capital position of a broker-dealer firm.

First Boston remains concerned, however, about the wisdom of authorizing the SEC to gather information on a routine basis. We continue to believe that such indiscriminate "monitoring" would inevitably lead to regulation of the activities and risks engaged in by the affiliates that the agency monitored. The SEC's Memorandum asserts that First Boston has no basis for concern since the SEC has no intention of using the risk assessment authority to regulate the activities of such affiliates. The issue, however, is not one of intent but rather of effect. The Memorandum suggests that the agency would use information about activities of affiliates to take action -- "to address" any concerns raised by such information (Memorandum at 16) and "to consult with SROs and domestic and foreign government agencies in order to plan responsive action ..." (id. at 17). While the purpose of such action might not be to regulate the affiliates, it would no doubt have that effect. This raises broad policy implications that have not, to date, been explored.

Finally, the SEC's attempt to justify the risk assessment section on the basis of references to the authority of foreign regulators is unpersuasive. The SEC's Memorandum argues that, as a result of structural differences between the U.S. and foreign markets, foreign securities regulators have access to "more information" than the SEC about certain risky financial activities engaged in by broker-dealers and their affiliates. The Memorandum states that in the U.K. and Japan certain activities are "for the most part," "generally," or always conducted inside of regulated banks or securities firms rather

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1/(...continued)
dealer. These appear to be highly speculative. Nevertheless, to the extent that they might lead to an impaired capital condition, the broker-dealer would in all likelihood be required by the SEC's rules to file an early warning report -- a point that is not mentioned in the SEC's analysis.

than in unregulated affiliates (id. at 18-20). Thus, according to the SEC, Japanese and U.K. regulators have greater access to information about these activities.

The SEC's structural analysis appears to overlook, however, a major difference between U.S. and foreign laws. While First Boston has not attempted to engage in an exhaustive comparative analysis of the differences between U.S. and foreign laws, banks and broker-dealers in the U.K. and Japan can apparently engage in the activities cited by the SEC because the net capital rules in those countries are not as stringent as those in this country. The net capital rules in this country effectively drive risky activities outside the firm and insulate the firm from the activities. In the absence of comparable net capital rules, foreign regulators would have a far greater need for information about such activities. Thus, the SEC's legislative proposal would merely place additional burdens on U.S. broker-dealers for no reason.2/

The SEC also argues that First Boston is incorrect in arguing that the new reporting requirements contemplated by the bill would place U.S. broker-dealers at a competitive disadvantage in the global marketplace. We pointed out in our letter that the risk assessment section would permit the SEC to require regular reporting concerning the operational and financial condition of affiliates that have no dealings with their broker-dealer relatives and that this goes beyond what is required in the U.K. and Japan (First Boston at 5). The SEC's Memorandum argues that this is incorrect, asserting that securities regulators in those countries in fact have the legal authority to require broker-dealers to file periodic reports of the type contemplated by the bill (Memorandum at 18-19). While we question in certain respects the SEC's analysis of the laws in the U.K. and Japan, there appears to be no dispute that securities regulators in those countries do not require the type of regular reporting contemplated by the bill. Our concerns about competitive disadvantages are not answered by merely arguing that other domestic and regulators could legally impose the same type of reporting requirements as the SEC where, as here, there is no indication that they intend to do so.

2/ Moreover, it is worth noting that, even if foreign regulators did have "more information" than the SEC about certain activities, this would not further the SEC's case. The risk assessment provision at issue here is not limited to information about affiliates that are engaged in specified financial activities. It extends to any affiliate, irrespective of its business.

We recognize that the SEC's Memorandum indicates that the agency is willing to accept a statutory disclaimer of any power to engage in substantive regulation of non-broker-dealer affiliates and to "clarify" the definitions of "associated persons" and a "material impact" on a broker-dealer in order to remove concerns about the possibility that the agency would impose routine reporting requirements that are both unnecessary and burdensome. We feel that these are the bare minimum steps that must be taken if the Congress disagrees with our argument and decides that the SEC should have new powers to collect certain information about affiliates of broker-dealer firms. The bill must at least be amended to include (in the statute itself and not the legislative history) the disclaimer and definitions of the terms "associated persons" and "material impact" that are adequate to ensure that the SEC does not later impose reporting requirements that are unnecessarily intrusive and burdensome.

In conclusion, while First Boston is pleased to support the SEC in its request for large-trader reporting data to assist its compliance efforts, we remain opposed to giving them unrestricted authority to require broker-dealers to report information about their non-broker-dealer affiliates. We think it is important for all of us to recall one of the lessons of the 1960's and 1970's, which is that over-reaching legislation may not only prove to be unworkable and, thus, not address the original problem which triggered the legislative effort, but may ultimately result in a whole series of new and unforeseen problems and market dislocations. I am reminded of the wisdom contained in a comment by Lane Kirkland addressing the consequences of well-intended legislation: "All problems are caused by solutions." We think it important for the Commission and the Congress to protect the effectiveness of the net capital rule and not to undermine it by diverting the regulators' attention to collateral matters. I would add a caveat of my own: if it ain't broke, don't break it.

Again, Mr. Chairman, thank you for considering our views on these very important subjects.

Sincerely,

Mike

Michael Raoul-Duval
Managing Director

The EQUITABLE
Financial Companies

Stephen J. Friedman
Executive Vice President
and General Counsel

FEDERAL EXPRESS

October 16, 1989

Hon. Christopher Dodd
Chairman
Securities Subcommittee
FD-534 Dirksen Senate Office Building
Washington, DC 20510

Hon. John Heinz
SR-277 Russell Senate
Office Building
Washington, DC 20510-3801

Dear Chairman Dodd and Senator Heinz:

The Equitable Life Assurance Society of the United States ("The Equitable"), a New York mutual life insurance company, appreciates the opportunity to comment on The Market Reform Act of 1989. The section of S.648 dealing with "Risk Assessment for Holding Company Systems" would authorize the Securities and Exchange Commission (the "Commission") to require a registered broker dealer to report certain information (as may be prescribed by regulation) regarding "any aspect of the financial or operational condition of its associated persons (emphasis added)" that the Commission determines would be reasonably likely to have a material impact on the registered broker dealer. Certain classes of regulated entities would be excluded. In addition, the section gives the Commission broad discretion to provide exemptions for certain entities or classes of entities.

The Equitable shares the Commission's concerns regarding the financial and operational stability of broker dealers. We believe, however, that the broad discretion given the Commission to require reporting of information concerning entities it currently has no power to regulate is of great concern, particularly to large, diversified financial services organizations such as The Equitable.

The Equitable Life Assurance Society
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To fully appreciate the scope of the legislation, it is necessary to remember how broad the definition of "associated person" is under the Securities Exchange Act of 1934 (the "1934 Act"). An associated person is any person directly or indirectly controlling, controlled by or under common control with, another person.

The Equitable is itself a registered broker dealer, and it in turn controls, directly or indirectly, seven registered broker dealers. These range from Donaldson, Lufkin & Jenrette Securities Corporation, a full service broker-dealer conducting a general securities business and a wide range of investment banking activities, to Elafund, Inc., registered as a broker dealer solely for the purpose of marketing insurance funding agreements issued by The Equitable. The Equitable also has seven major operating subsidiaries. Each of these operating subsidiaries has organized numerous subsidiaries and other entities for a wide range of purposes, from single purpose subsidiaries to act as general partners in investment partnerships, to companies formed to hold various types of investments, to investment vehicles to provide individuals and institutions with a wide variety of financial products. Technically, each of these many entities would be considered to be under common control with the other, and each would be an "associated person" of each of The Equitable's seven broker dealers.

The problem is compounded by the scope of the information the legislation permits the Commission to require. S.648 provides that "reports prescribed by the Commission under this section may include, but shall not be limited to, information concerning assets, liabilities, contingent liabilities, material contracts, loan commitments, trading or investment positions, lines of credit, letters of credit, and financial guarantees."

Given the breadth of this grant of authority, the Commission could conceivably impose reporting requirements similar to or greater than imposed on public companies by the other provisions of the 1934 Act. Under the 1934 Act, the burdens imposed are justified by the need to provide the public with accurate and timely information concerning companies the public has chosen to invest in directly. Here, entities which are wholly owned subsidiaries of other companies with indirect relationships to a broker dealer (e.g., sister corporations related only under the "common control" concept) could be required to report.

We recognize that the legislation grants the Commission broad exemptive authority. The exemptive process, however, can be costly and time-consuming, and given the complex and constantly evolving structure of large financial institutions, it may be extremely difficult to fashion class exemptions quickly enough to narrow the scope of the information sought. We believe a large, diversified financial services organization should not be required to rely solely on the discretion of the Commission to relieve it from the burdens this legislation would impose.

We are also concerned about the proposed Commission comment exempting subsidiaries of bank holding companies. This change would result in discrimination between subsidiaries of bank holding companies which would be exempt (except for registered broker dealers) and subsidiaries of insurance companies, which would be covered. Given the number of subsidiaries The Equitable has, the burden the legislation imposes would place The Equitable and other large diversified financial institutions at a competitive disadvantage to bank holding companies.

We respectfully suggest that the legislation be narrowed to focus more specifically on areas of concern to the Commission. Broker dealers of a certain minimum size might be excluded. Broker dealers engaged in certain types of limited activities, such as sale of insurance products or institutional placements, might be excluded. The "associated person" concept might be limited in the context of this legislation to require that information be required concerning only the ultimate parent of broker dealers of a certain size or engaged in certain specified activities. Subsidiaries (other than registered broker dealers) and other types of entities under the control of all of the types of institutions enumerated in paragraph (2) could be exempted from the reporting requirements.

We believe it inappropriate to expand the Commission's authority so broadly into areas it has traditionally not regulated. The burdens of complying with the proposed legislation could be enormous, and the exemptive process envisioned by the legislation lengthy, time-consuming, costly and ineffective. While we share the Commission's concern with the stability of broker dealers and the financial markets generally, we believe a more narrowly focused proposal would adequately address that concern without unduly burdening previously unregulated entities.

Very truly yours,

Stephen J. Friedman

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John B. Manning, Jr.
Vice President
General Counsel
Office of the General Counsel-Trading

Merrill Lynch

October 19, 1989

The Honorable Christopher J. Dodd
Chairman
Securities Subcommittee
Committee on Banking, Housing, and
Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, D.C. 20510-6075

The Honorable John Heinz
United States Senate
277 Russell Senate Office Building
Washington, D.C. 20510-3801

Dear Chairman Dodd and Senator Heinz:

We at Merrill Lynch appreciate the opportunity to submit our views on S. 648, the Market Reform Act of 1989, originally proposed by the Securities and Exchange Commission ("SEC" or "Commission"), that is currently being considered by the Securities Subcommittee ("Subcommittee"). As a preliminary matter, we heartily support your efforts and those of the SEC to facilitate improvements in clearance and settlement systems, the surveillance and monitoring of market transactions, and the collection of pertinent information on market participants in response to perceived inadequacies, particularly during and after the market crisis of October 1987, in certain capital markets and oversight functions. As the Subcommittee is aware, we have worked closely with the Congress, the SEC, our other regulators and the SROs in their ongoing efforts to improve these systems, to expand and standardize internal recordkeeping, and to improve our own and the industry's response time to regulatory inquiries.

At the same time, we feel that certain provisions in S. 648 ought not to be enacted without further study of the problems that they are designed to address, in certain instances because the nature and extent of the problem has not been clearly defined, and in others because the provisions themselves are unduly broad in addressing the perceived problems. In addition, certain of these proposals would affect market participants inconsistently for reasons that appear not to be related to their underlying purposes.

In our view, the large trader reporting provision represents an extremely broad grant of authority to the SEC, based on issues that it would likely not resolve. It has been justified by analogy to large trader reporting in the futures market which is inapt, and, conclusory protestations to the contrary notwithstanding, we believe that the implementation of such a provision would jeopardize the confidentiality of clients' identities and strategies, and could well drive such business offshore. Its effect on the willingness of global investors to remain in the U.S. public markets deserves cautious consideration.

In addition, the holding company risk assessment provision, apparently designed to permit the SEC to determine the potential risk exposure of regulated broker-dealers due to the financial condition or the activities and risk profiles of their affiliates, would provide the SEC with such risk assessment data for only a small percentage of broker-dealers, due to the exemptions that would be set forth in (or granted by the SEC under) the statute. On the other hand, as to those broker-dealers to which it would apply, the bill would give overly broad regulatory jurisdiction to the SEC. While we understand the market concerns underlying this proposal, we do not believe that such a significant shift in the regulatory purposes of broker-dealer regulation--from customer protection to broker-dealer viability--should be enacted without a thorough study of the issues. At a minimum, any such provision should be carefully crafted to address the results of such an analysis, articulating precisely both the areas of regulatory concern and the particular disclosure subjects to which the SEC's jurisdiction would extend.

Large Trader Reporting

Section 3 of S. 648 would require every person effecting "large" transactions in publicly traded securities to file reports on those transactions in the form, frequency and detail prescribed by the Commission. The SEC thus would be granted very broad discretion both to define the triggering event and to prescribe the form and content of such reports. As the Subcommittee is aware, the Commission presently has the authority to require broker-dealers to maintain information regarding securities transactions and to provide it to the Commission on request. The Commission asserts, however, that it needs more routine filing for monitoring and surveillance purposes.

In this respect, the Commission has noted that reconstruction of securities market information was more difficult than reconstruction of similar commodities information in connection with the various studies of the 1987 market break, and the large trader reporting proposal has been analogized to large trader reporting in the commodities markets. The large trader reports required by the CFTC, however, do not facilitate market reconstruction, since, unlike this proposal, they involve reports of changes in position and not detailed, trade-by-trade information. Hence, the information that would be required by this report would involve transactional disclosures that would go significantly beyond those required by the CFTC reports. In addition, large trader reporting in the futures markets simply does not encompass the large number of instruments, transactions and market participants that would be affected by Section 3 of S. 648.

Merrill Lynch has long supported the Commission's goal of effective market oversight. We have evolved as a securities firm subject to a statutory scheme of self-regulation, and have always viewed ourselves in this respect as a partner of the Congress, our regulatory agencies and the SROs in which we participate. Consequently, we have always considered effective regulation and efficient regulators to be beneficial to our capital markets. We are unconvinced in this instance, however, that the broad data-gathering authority requested by the SEC is necessary to enhance the Commission's effectiveness, and we are concerned that, as a practical matter, this proposal would impose a significant burden on broker-dealers without corresponding regulatory benefits.

The kinds of transaction information that the SEC has indicated it would seek under this provision already are available through existing, marketwide systems, such as the electronic blue-sheeting system designed by the Intermarket Surveillance Group, which provides for quick, standardized responses to SRO and Commission requests. This system has been significantly improved since 1987, and continues to be improved. Although blue sheet information is currently required within a 10-day period, the SROs have the authority to require by rule that the information be provided within a shorter time. In addition, the New York Stock Exchange now requires daily program trading reports that have significantly facilitated the timely reconstruction of program trading activity.

In considering this proposal, it is important to bear in mind that it would compel disclosure of the beneficial ownership of equity securities in an unprecedented manner. As you know, equity investors often accumulate shares on a confidential basis, for a variety of legitimate purposes, up to certain reporting thresholds that are set forth in the Securities Exchange Act. These investors may, for example, be "testing the market" with a view ultimately to seeking control through a tender offer or merger proposal. In such circumstances, a comprehensive set of reporting requirements limits the extent to which they can accumulate shares without public disclosure, under a statutory scheme designed to strike a balance between bidder and target in a contest for corporate control.

Routinely providing data as to the identity of such investors on a trade-by-trade basis, even in a confidential filing, could jeopardize the confidentiality of clients and their strategies, and clearly will cause such clients to be concerned about the premature disclosure of such information to a potentially large audience. And frankly, those concerns wil persist even in an environment in which the information is designated as confidential, but is available to numerous regulators, legislators, and their staffs.

Such a concern may cause certain institutional clients ultimately to seek to effect transactions outside of the United States, an alternative that increasingly is available as a result of the globalization of the capital markets. Consequently, we have a more fundamental concern than the confidentiality of client information and strategies. We believe that the broadened authority sought by the Commission for large trader reporting could have a significant impact on the competitive position of the U.S. securities markets.

In short, we believe that your consideration of this provision should involve an analysis of the legal and practical burdens that it would impose; the kinds of information currently available to the SEC and its staff; whether there are less intrusive means to enhance that information; and its competitive effect on our markets. On balance, we do not believe that it should be enacted, particularly in the absence of demonstrated abuses that would justify so far-reaching an initiative.

Holding Company Risk Assessment

Section 4 of S. 648 would empower the Commission to require registered broker-dealers and certain other entities to file reports concerning any "transaction, agreement, contract, arrangement, or event (or any series or combination thereof)" related to its affiliates that "the Commission determines will have or is reasonably likely to have a material impact on the financial or operational condition" of the broker-dealer or other entity. Foreign banks, domestic bank holding companies, savings and loan holding companies, insurance companies, and futures commission merchants would be exempted from this provision if they are regulated by another agency having the authority to collect similar information. The Commission would also be authorized to exempt other entities; it may base exemptions on "the primary business of any associated person, the nature and extent of domestic or foreign regulation of the associated person's activities." The Commission has requested this authority because it is concerned that the failure of a broker-dealer affiliate could adversely affect the availability of credit to the registered broker-dealer and, ultimately, its viability.

The increasingly complex organizational structures of financial services firms, with both regulated and unregulated affiliates, may raise legitimate issues as to the impact on a broker-dealer of the unregulated activities of its affiliates. At the same time, however, the historical statutory and regulatory underpinnings of broker-dealer regulation have involved the protection of customer funds and securities, *i.e.*, to ensure, through mechanisms such as the net capital rule and the customer protection rule, that customers would be made whole in the event of broker-dealer insolvency. And the Commission staff has indicated clearly that these rules, in its view, are effective in achieving that regulatory objective.

Section 4 of S. 648 would involve a fundamental shift in the regulatory purposes of broker-dealer regulation, which should be undertaken only after careful and thorough evaluation of the circumstances motivating such a departure. A formal study should be undertaken of factors, such as concentration in the financial services industry, the increasing extent of merchant banking activities on the part of U.S. securities firms, fundamental shifts in risk-profile as a result of the proliferation of international financial services conglomerates, and the likely impact of the failure of a broker-dealer on other firms and on our markets, even if its customer funds and securities are fully protected. In our view, such a study should also involve consideration of different potential approaches and a thorough analysis of the benefits and burdens of each. The results of such a study might well form the predicate for a modification in the statutory basis of broker-dealer regulation. We strongly believe, however, that such a significant statutory departure from the regulatory premises governing this area should be implemented only after a formal study.

The Commission has stated that "knowledge of the financial and operational condition of the entire broker-dealer holding company complex is essential to the SEC's ability to anticipate when, or understand why, banks have withdrawn credit lines or restricted lending arrangements because of a deterioration of the financial health of affiliated parties." The necessity for this complete knowledge would seem to compel the conclusion that certain exemptions that are set forth in this proposal may not be appropriate or reasonable in light of its purposes. Therefore, we believe that the study of the risk assessment issue that we have advocated should also involve careful consideration of both the precise sorts of information that should be reported and the nature of appropriate exemptions, in light of the regulatory objectives sought to be achieved.

For example, the rationale behind exempting broker-dealers with affiliates that are regulated by other agencies from reporting to the Commission on those affiliates is not clear to us. If the Commission is seeking to create a complete picture of a broker-dealer's financial condition, creditworthiness and risk profile, then the fact that one or more of its affiliates are otherwise regulated, in some cases by an agency the legislative charter of which may have little to do with the SEC's objectives, should not limit the inquiry. Comprehensive risk assessment would seem to require this result. Certainly, the study should analyze the sorts of information reported to other regulators, its public availability, and whether it would be available or useful to the SEC in its risk analysis.

In addition, the bill appears to contemplate that the Commission might exempt broker-dealers from this provision if their parent companies were not primarily engaged in the financial services industry. At a minimum, the study should carefully consider the appropriate limits of this type of exemption. It may be, for example, that it would make little difference whether the broker-dealer's insolvency was occasioned by the diminution of the creditworthiness of its holding company parent or by the loss of a material commercial contract by an operating parent. And while the commercial particulars of such a contract would be irrelevant for risk assessment purposes, the contract itself may be highly relevant.

Merrill Lynch

We believe that this study would contribute significantly to the appropriate resolution of the holding company risk assessment issues. We would be pleased to participate in the study, and believe that it would result in the development of the most appropriate possible approach to the issues addressed by this proposal.

Thank you for this opportunity to provide our views on this important legislation. We look forward to working with you as you continue your consideration of these issues.

Very Truly Yours,

John B. Manning, Jr.

cc: Martha Cochran
Michael Stein
Bradley Belt
Ira Paull